Tax Elections & Private Bargaining

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Focal points for private bargaining occur every instance the tax law provides a tax election that directly affects multiple taxpayers. These elections explicitly enable, and actually incentivize, the taxpayers to cooperate in order to reduce their aggregate tax burden. For example, divorced parents of a dependent child can negotiate about which parent will be entitled to take the dependency exemption for the child. If the parents work together, they can identify the parent for whom the dependency exemption will have the most value. By electing to allocate the dependency exemption to that parent, they can reduce their aggregate tax burden and share in the tax savings. Yet transaction costs, cognitive biases, and sheer irrationality can impede taxpayers' abilities to bargain effectively. Thus, in order to facilitate bargaining and reduce bargaining costs, this article analyzes how impediments to negotiation should affect the design of two key election parameters: (1) the allocation, among the affected taxpayers, of the power to make the election, and (2) the default rule that will apply if no election is made. As examples, this article examines tax bargaining focal points in three settings where the negotiating dynamic can differ significantly: divorce, employment, and corporate acquisitions. In addition to making a few specific proposals for modifying these elections, this article provides generalizable recommendations about how to design tax election parameters in order to facilitate effective and efficient bargaining.
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I. INTRODUCTION

Consider Pam and Larry, the divorced parents of a little boy named Sonny. Pam and Larry share legal custody of Sonny, but Sonny resides primarily with Pam. When Pam did her taxes last year, she took a

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1 The facts in this hypothetical example are based, very generally, on several cases in which the Internal Revenue Service (Service) challenged a divorced parent’s entitlement to take a dependency exemption. See, e.g., Spanier v. Comm’r, 106 T.C. 1 (2004) (involving Pamela and Lawrence Spanier and their three children).

2 I use stereotypical gender roles in this custody example, and throughout the article, because these gender roles actually reflect the majority of situations. The most common patterns for the allocation of custody of minor children in divorce are (1) sole-maternal custody and (2) the pattern used in the example (joint legal custody and mother residential custody). See U.S. CENSUS BUREAU, SUPPORT PROVIDERS: 2002, HOUSEHOLD ECONOMIC STUDIES 5 (2005); see also U.S. CENSUS BUREAU, CUSTODIAL MOTHERS AND FATHERS AND THEIR CHILD SUPPORT: 2007 2–3 (2009) ("The legal custody arrangement specifies authority
dependency exemption for Sonny. Pam was in the 10% marginal tax bracket, so a $4000 dependency exemption was worth $400 to her. Although Pam was entitled to the dependency exemption under the default rules in the tax law, Pam and Larry could have agreed that Larry would take the dependency exemption instead. Larry was in the 25% marginal tax bracket, so the dependency exemption would have been worth $1000 to him — $600 more than it was worth to Pam. Thus, if Pam and Larry had negotiated about the allocation of the dependency exemption, they could have shared that extra $600, making both of them better off. Congress, in the Internal Revenue Code, explicitly gave Pam and Larry an opportunity to strike a private bargain that would reduce their aggregate tax burden, and they did not take advantage of this chance.

In this situation and many others, the tax law creates focal points for
to make educational, religious, and medical decisions for children. Residential [or physical] arrangements indicated where children will primarily live.”); Marjorie Lindner Gunnoe & Sanford L. Braver, The Effects of Joint Legal Custody on Mothers, Fathers, and Children Controlling for Factors that Predispose a Sole Maternal versus Joint Legal Award, 25 L. & HUM. BEHAV. 25, 26 (2001). Similarly, this article follows stereotypical gender roles in the context of alimony as well because, again, this reflects the gender dynamic in most contexts where alimony is awarded — alimony payments more commonly flow from the ex-husband to the ex-wife than vice versa. See U.S. CENSUS BUREAU, SUPPORT PROVIDERS: 2002, HOUSEHOLD ECONOMIC STUDIES 9 (2005).

3 I.R.C. § 151(c).
4 This is a stylized example that uses figures and rate brackets that allow for easy computations. Also, this example focuses on federal income tax consequences, and it sets aside state tax issues.
5 The dependency exemption for 2010 was actually $3650, but rounding up to $4000 allows for easier computation in the example. Rev. Proc. 2009-50, 2009-45 I.R.B. 617 (stating the exemption amount for 2010).
6 $4000 * 10% = $400
7 $4000 * 25% = $1000
8 Unless otherwise stated, all references herein to the “Code” or to a “section” refer to the Internal Revenue Code of 1986, as amended.
9 For another example, consider Ed and Irene, who divorced after 20 years of marriage. See e.g., Richardson v. Comm’r, 125 F.3d 551 (7th Cir. 1997) (providing, very generally, the basis for this example). Ed, who was the primary breadwinner, paid alimony to Irene. But, Irene did not realize that she would have to pay taxes on the alimony she received, nor did she know that Ed would be able to take a deduction for the alimony he paid to her. So, Irene did not take the tax cost into account when determining how much alimony to ask for, and as a result, Irene’s alimony provided her with much less after-tax income than she anticipated. Irene was unable to take advantage of the opportunity to bargain with Ed about the tax costs and benefits arising from the alimony arrangement. Ed did not compensate her for any of the tax she had to pay on the alimony she received, and he was
These focal points occur every place the tax law provides an explicit tax election that directly affects the tax treatment of multiple taxpayers. These elections, pursuant to which taxpayers can merely tell the Internal Revenue Service (Service) how they would like to be treated for tax purposes, increase the salience of opportunities for tax-minimizing coordination among taxpayers. Yet transaction costs, cognitive biases, and sheer irrationality can impede taxpayers’ abilities to able to keep the entire value of the tax deduction for alimony, without having to share that benefit with Irene.

See Richard H. McAdams, Coordinating in the Shadow of the Law: Two Contextualized Tests of the Focal Point Theory of Legal Compliance, 42 LAW & SOC’Y REV. 865, 865–75 (2008) (arguing that “[i]n situations where people have an incentive to coordinate their behavior,” law can make a particular behavior salient, thereby influencing and effectively endorsing coordination between individuals about that behavior). Clearly, much of the tax law provides background rules that serve as a backdrop for private negotiation between taxpayers. Sometimes the availability of this cooperative tax planning is implicit in the law, as a result of the mere existence of different tax regimes. For example, an investor and representatives of a business enterprise may negotiate about the terms of the investor’s economic investment in the business enterprise, knowing that the tax consequences of debt investments differ from the tax consequences of equity investments. In contrast, the focus of this article is the availability of cooperative tax planning that is intentionally and explicitly provided in the tax law via explicit tax elections that directly affect multiple taxpayers.

An explicit tax election is an opportunity for a taxpayer to choose his tax treatment by “merely tell[ing] the Internal Revenue Service (“IRS” or “Service”) how he wishes to be treated for tax purposes; he need not take any specific non-tax actions or structure his financial or legal dealings in any particular way in order to obtain his preferred tax treatment.” Heather M. Field, Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax, 47 HARV. J. ON LEGIS. 21, 22 (2010).

Of course, all tax elections affect multiple taxpayers, at least indirectly. This is because, an individual’s decision to make a tax election that reduces his tax burden also reduces the amount of revenue collected by the government, thereby indirectly affecting all of the other U.S. taxpayers (i.e., either because the government will have less money available to provide government services or because the other taxpayers will have to pay more tax in order for the government to collect a particular amount of revenue). This article generally does not focus on these taxpayers who are affected indirectly; instead, as the examples provided herein will demonstrate, this article generally focuses on taxpayers who experience an increase or decrease in their tax burdens (or in the tax burdens of a corporation in which they hold an interest) as a direct result of the terms of a tax election.

In part, this negotiation is incentivized because the election is generally not a zero-sum game among the affected taxpayers. As the example above with Pam & Larry illustrates, coordination between taxpayers with respect to the making of an election can reallocate to the taxpayers money that would have otherwise been collected by the government. Cf McAdams, supra note 10, at 869–71 (discussing the need for coordination among private parties, particularly in situations where both parties can benefit from that cooperation).
bargain effectively about these tax issues.

But, why should we care if taxpayers have trouble reaching a private agreement about how to make a tax election in the way that best reduces their aggregate tax burden? After all, we face significant budget deficits, and the government collects more revenue when taxpayers fail to make tax-minimizing choices. There are several responses.

Sometimes, part of Congress’s policy rationale for providing an election is to facilitate “private ordering” and negotiation among individual taxpayers. Also, in certain circumstances, tax policymakers assume that taxpayers can bargain effectively with each other, and the policymakers explicitly rely on that assumption when designing tax regulations. In these contexts, impediments to bargaining can frustrate Congressional intent and undermine the efficacy of regulations. Moreover, if policymakers have seen fit to provide a tax election for good reason, the benefits of the election should be available to all sets of taxpayers and not merely the sophisticated or well-advised taxpayers who can overcome the impediments to reaching agreements that maximize their aggregate welfare. Further, as long as these focal points for tax bargaining continue to be part of the tax law, we must acknowledge that taxpayers will have an incentive to bargain around these focal points, whether or not that bargaining is desirable. Thus, reducing the transaction costs of this bargaining would seem to be in the interests of even those who object to the presence of elections in the tax law. Additionally,
barriers to bargaining may result in unexpected or undesirable distributional consequences and may pose an increased risk of government whipsaw.

Where impediments to bargaining create these concerns, we should think carefully about the bargaining setting that is created by the parameters of the tax bargaining focal points.\textsuperscript{18} Thus, in order to facilitate bargaining and reduce bargaining costs, this article argues that policymakers should (and how policymakers should) take impediments to bargaining into account when designing the election parameters. This is particularly important when policymakers (1) determine how the power to make an election is allocated among the affected taxpayers and (2) select the default rule that will apply if no election is made. Further, this article attempts to provide some guidance about how to design these parameters in different contexts.

As examples, this article will discuss tax bargaining focal points in three settings where the bargaining dynamic can differ significantly: divorce, employment, and corporate acquisitions. Part II explains elections available in these contexts in order to illustrate the incentives that taxpayers have to negotiate about whether to make an election. Part III explores taxpayers' abilities to reach agreements about whether to make elections that minimize their aggregate tax burden. This discussion proceeds, first, under the assumptions of the Coase theorem (no transaction costs and rational parties), and then, in light of impediments to bargaining (including transaction costs, cognitive biases, and sheer irrationality). This part concludes that impediments to bargaining can be significant and should be taken into account when designing the parameters of tax bargaining focal points.

Part IV analyzes how to design key election parameters in order to facilitate bargaining and reduce bargaining costs. Specifically, Part IV.A recommends that elections should generally be made jointly by the taxpayers affected by the election, rather than unilaterally by one party. This part argues that joint elections can empower the less-informed

\textsuperscript{18} Of course, it is entirely possible that, at least in certain cases (perhaps divorce), that the parties reach bargains without regard to the underlying legal parameters or entitlements. \textit{See} Robert C. Ellickson, \textit{Order Without Law: How Neighbors Settle Disputes} VII (1991) ("[P]eople frequently resolve their disputes in cooperative fashion without paying any attention to the laws that apply to those disputes.").
bargaining party, facilitate cooperation by leveraging cognitive biases, and minimize government whipsaw. This discussion also addresses ways to minimize the potential adverse consequences of joint elections. Then, Part IV.B discusses the more difficult issue of selecting default rules for explicit tax elections that serve as focal points for private bargaining. This part explains the potential information-forcing benefits of "penalty default rules" (i.e., default rules that are purposefully set at what one or more parties would not want, in order to give those parties an incentive to contract around the default) and the potential transaction-cost-reducing benefits of "preference-meeting default rules" (i.e., default rules that most closely reflect the tax treatment that the directly affected taxpayers would likely have bargained for, assuming costless bargaining and assuming that taxpayers generally prefer to minimize their tax burdens). Further, this part evaluates our ability to effectively design these types of default rules, and assuming that they can be designed, this part tries to weigh the costs and benefits of these different alternatives. Finally, this part explains that various other policy considerations (like distributive and other social policy concerns, simplicity, and administrability) may influence the default rule determination when the penalty default/preference-meeting default analysis produces conflicting or indeterminate results.

Part V provides generalizable guidance about how to systematically coordinate the analyses of the two election parameters in different situations. As examples, this part returns to the tax bargaining focal points in the divorce, employment, and corporate acquisition contexts. As a result, this part makes a few specific recommendations for modifying these elections. Part VI concludes.

II. EXPLICIT ELECTIONS AS FOCAL POINTS FOR TAX BARGAINING

The tax law includes several explicit elections that affect multiple taxpayers. These taxpayers have an incentive to negotiate with each other about whether to make the election. These opportunities for negotiation arise in a variety of contexts, including in connection with divorce, employment, and corporate acquisitions.19 To the extent that you are

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19 Entity classification and corporate/partnership elections are additional common contexts in which these opportunities for negotiation arise. For example, all shareholders are required to consent to a corporation's S corporation election, but a check-the-box election under Treasury Regulation section 1.7701-3 is made by the entity itself; the tax law does not mandate that the members of the entity all consent to the election. Additionally, other corporate elections and partnership elections are generally made by the entity itself; although these elections affect the shareholders and partners, respectively, these owners are generally only entitled to the right to consent to (or vote on) such elections to the extent that the
familiar with the operation of, and incentives created by, these tax elections, you may want to skip directly to Part III.

**A. Elections Available in Connection with Divorce**

In the divorce context, the election regarding the tax treatment of alimony payments and the election regarding the allocation of the dependency exemption can impact the tax treatment of both former spouses, thereby setting up focal points for negotiation. The tax consequences of these elections and the manner in which the elections are made affect the desirability of the elections and thus affect the incentives that the parties have to negotiate about whether to make the elections. These elections will be discussed briefly in turn.

1. **Tax Treatment of Alimony Payments**

Alimony payments are generally deductible by the payor and

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20 Specifically, Part II.A addresses the elections available in connection with the tax treatment of alimony and the allocation of the dependency exemption among unmarried parents. I.R.C. §§ 71(a)–(b), 215(a), 152(e). Part II.B addresses the section 83(b) election available in connection with the transfer of restricted property in compensation for services. Part II.C addresses the regular section 338 election, the section 338(h)(10) election, and the section 336(e) election, all of which are available in connection with corporate acquisitions.

21 Also, readers may also want to skip directly to Part III on the off chance that they are more interested in the conceptual aspects of this article and are less interested in the specific details of the relevant elections.


24 Alimony payments are distinguished from child support payments, which are treated differently for tax purposes. See I.R.C. § 71(e); see also Bigler, supra note 23 (arguing that alimony payments and child support payments should be treated in the same way for tax
includeable in the income of the recipient. However, the parties can opt out of this tax treatment so that the payment would not be includeable in the income of the recipient and would not be deductible by the payor. To do so, the divorce or separation instrument must designate the alimony payment as not includeable in the recipient’s gross income and not deductible by the payor, and the alimony recipient must attach a copy of the divorce or separation instrument to her “first filed return of tax (Form 1040) for each year in which the designation applies.” The “divorce or separation instrument” in which the designation must be made can include a written separation agreement among the parties and any subsequent writing signed by both parties that refers to the original written separation agreement. Thus, it is possible that, as long as there is joint action by both former spouses, they could “change the tax treatment of the payments from year to year.”

The default tax treatment of alimony payments (deductible by the payor, includable by the recipient) generally results in an overall tax benefit to the former spouses, in the aggregate, if the payor is in a higher tax bracket than the recipient. If, however, the recipient is expected to be in a higher tax bracket than the payor, the parties may wish to elect out of the default treatment either permanently or in a given year, in order to achieve a

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26 I.R.C. § 71(a).
27 Historically, this is how alimony payments were treated prior to 1942:

[N]either deductible by the payor nor includable by the payee. In 1942[,] however] Congress enacted the statutory predecessors of §§71 and 215 of the Internal Revenue Code, taxing alimony to the recipient and allowing a deduction to the payor. The purpose of this statutory ‘income splitting’ rule was to eliminate variations in the taxation of alimony attributable to differences in local law and to moderate the effect of high wartime tax rates on the payors of alimony. McMahon, supra note 23, at 222 (citations omitted).

28 The designation generally needs to be specific to ensure that the Service will respect the non-alimony tax treatment.
29 I.R.C. § 71(b).
30 See supra note 2 (explaining this article’s use of stereotypical gender roles).
32 Id. The divorce or separation instrument can also include a judicial decree of divorce. Id.
34 This is a reasonably good assumption given the factors considered when determining the amount of alimony payments.
better overall tax result for the former spouses. If the election is made, the alimony would become nondeductible to the payor and nonincludable for the recipient. The election shifts the nominal tax burden from the recipient to the payor, and the payor would be worse off economically because of his increased tax bill. To induce the payor to join in making the election and to accept this adverse consequence, the parties may negotiate, and the recipient may agree to accept a smaller alimony payment in order to compensate the payor for his increased tax burden.

2. Allocating the Dependency Exemption for a Child of Divorced Parents

Divorced parents with a dependent child must determine which parent (if either) will be able to take the dependency exemption for such child. If the custodial parent would, under the regular rules of section 152, be entitled to claim the dependency exemption for the child, the custodial parent has the power to release that dependency exemption to the noncustodial parent under section 152(e). In order to enable the noncustodial parent to take the dependency exemption, the custodial parent must sign a written declaration attesting that she will not claim the dependency exemption for the child for the taxable year, and the

35 For an example of language that can be included in a divorce or separation instrument to designate a payment as non-alimony for tax purposes, see WOFFORD, supra note 33, Worksheet 12.

36 This determination is relevant not only for divorced parents of a dependent child, but also for parents who were never married. I.R.C. § 152(e)(1)(A)(iii); Treas. Reg. 1.152-4(g)(ex. 11) (applying these rules to parents who never married). Further, the “dependent” with respect to whom a dependency exemption is available can be not only a minor child, but can also be a dependent child up to the age of 24 in certain circumstances, a disabled child of any age, and other qualifying relatives. I.R.C. § 152(a), (c)-(d). For simplicity, the discussion will focus on the context of dependent minor children of divorced parents, but the discussion is generalizable to a broader set of circumstances.

37 A custodial parent may not be entitled to claim the dependency exemption if the parents do not provide a threshold level of support of the child. I.R.C. § 152. However, for the remainder of the analysis, this article will assume that, setting aside any election, the custodial parent would be entitled to claim the dependency exemption under the regular rules of section 152. See also generally WOFFORD, supra note 33, at ¶¶ VII.C., VII.C.5.c.

38 While it is increasingly common for divorced parents to have some degree of joint custody of minor children, the Code still requires that one parent be characterized as “custodial” and the other parent characterized as “noncustodial,” based upon which parent has physical custody of the child for more nights during the year. I.R.C. § 152(c)(4); Treas. Reg. § 1.152-4(d) (2008). Where the child resides with each parent for an equal number of nights during the year, the parent with the higher adjusted gross income is treated as the custodial parent for that year. Treas. Reg. § 1.152-4(d)(4) (2008).

39 See supra note 2.
noncustodial parent must attach that declaration to his tax return for the taxable year.\textsuperscript{40} For taxable years beginning after July 2, 2008, the custodial parent's release of the dependency exemption must be on an IRS Form 8332 or must be a "document executed for the sole purpose of serving as a written declaration" releasing the exemption.\textsuperscript{41} Note that an effective election requires joint action because, although only the custodial parent must sign the declaration releasing the dependency exemption, the noncustodial parent must attach the declaration to his tax return.

The divorced parents may negotiate about the allocation of the dependency exemption, and in order to reach the best overall tax result for both parents, they will likely try to allocate the dependency exemption to the parent for whom it has the most value. This likely means allocating the dependency exemption to the parent in the higher tax bracket; however, the parents should be careful about this decision because the dependency exemption does get phased out for parents at very high-income levels.\textsuperscript{42} Additionally, the allocation of other tax benefits, such as the child tax credit, depends on the allocation of the dependency exemption,\textsuperscript{43} so the value of these other benefits should also be taken into account when parents negotiate about the allocation of the dependency exemption.\textsuperscript{44}

\textbf{B. The Employment Context: The Section 83(b) Election}

Another election that affects multiple taxpayers and that can serve as a focal point for negotiation among those taxpayers is the section 83(b) election. In general, when property is transferred in connection with the performance of services and the property is nontransferable and subject to a substantial risk of forfeiture, the recipient of the property does not pay

\begin{footnotesize}
\begin{enumerate}
\item I.R.C. § 152(e).
\item Treas. Reg. 1.152-4(e)(1)(ii) (2008). For taxable years beginning prior to July 2, 2008, the noncustodial parent could substantiate his claim to the dependency exemption by attaching a copy of the court decree or separation agreement. The substantiation requirement was changed because "[d]ivorce decrees, separation agreements, and similar instruments are complex documents that may be subject to differing interpretations governed by state law. . . . [T]his change will improve tax administration and reduce controversy." T.D. 9408, 2008-33 I.R.B. 323. Note that there is a grandfather rule providing that if the divorce decree was issued prior to July 2, 2008, the noncustodial parent may continue to use that decree as substantiation for his right to claim the dependency exemption. \textit{Id.}
\item I.R.C. § 151(d)(3).
\item \textit{But see} Rev. Proc. 2008-48, 2008-36 I.R.B. 586 (providing that a child will be treated as a dependent of a noncustodial parent for various provisions of the Code even if the custodial parent has not released the dependency exemption).
\end{enumerate}
\end{footnotesize}
current income tax on the value received; rather, the recipient includes the value of the property (less any amount paid for the property) in income only when the property first becomes transferable or when the restriction lapses.\textsuperscript{45} The employee,\textsuperscript{46} however, can make a unilateral election to change these tax consequences. If the employee makes an election under section 83(b), then he or she must take the value of the transferred property (less any amount paid for the property) into income in the year of the transfer; generally, no additional income tax will be imposed until the employee disposes of the property.\textsuperscript{47}

An employee may want to make the election, for example, if the value of the transferred property is low at the time of the grant (such that the immediate tax cost would be small) and/or if the value of the transferred property is expected to grow substantially by the time the restrictions lapse (such that the later appreciation could be taxed to him at capital gains rates rather than at ordinary income rates). In contrast, accelerating the tax event by making a section 83(b) election may not be desirable for the employee, for example, if the employee is concerned about forfeiting the property or if the immediate tax cost would be large.\textsuperscript{48}

The section 83(b) election affects the employer as well as the employee because the employee’s election affects the timing and amount of any

\textsuperscript{45} I.R.C. § 83(a).

\textsuperscript{46} These rules are applicable to service providers, generally, including independent contractors who receive restricted property in compensation for services rendered. For simplicity, the article will generally discuss the section 83(b) election in the context of the employee/employer relationship.

\textsuperscript{47} I.R.C. § 83(b)(1). In addition to the effect that the election has on the timing of the recipient’s income, the election also affects the character of the recipient’s income. Under the default rule, the recipient pays tax at ordinary income rates on the entire value of the property (less any amount paid for the property) at the time the restrictions lapse. In contrast, if an election is made, the recipient pays tax at ordinary income rates on the value of the property at the time of the grant (less any amount paid for the property), and he generally pays tax at capital gains rates on any further appreciation.

\textsuperscript{48} See generally Michael S. Knoll, The Section 83(b) Election for Restricted Stock: A Joint Tax Perspective, 59 SMU L. REV. 721, 729–36 (2006) (concluding that, under certain assumptions, the election may be unfavorable because “the election increases the employee’s taxes because she can do better by purchasing shares than by making the election”); David I. Walker, Is Equity Compensation Tax Advantaged?, 84 B.U. L. REV. 695, 707 (2004) (discussing situations in which it may or may not be desirable for an employee to make a section 83(b) election); Robert L. McDonald, Is it Optimal to Accelerate the Payment of Income Tax on Share-Based Compensation?, (Sept. 19, 2003), http://www.kellogg.nwu.edu/faculty/mcdonald/htm/ (demonstrating that it is often not optimal for an employee to make a section 83(b) election).
compensation deduction that may be available to the employer.\textsuperscript{49} Specifically, the employer (i.e., the transferor of the property) may take a compensation deduction in the taxable year in which the service provider includes the value of the property in income, and the amount of the deduction available to the employer is limited to the amount of gross income that the employee takes into account as a result of the transfer.\textsuperscript{50} Thus, if the employee makes a section 83(b) election, the employer will get a deduction in the current year in an amount equal to the employee's income inclusion. In contrast, if no section 83(b) election is made, the employer will not be entitled to a compensation deduction until sometime in the future when the property becomes transferable or the restrictions lapse, but the amount of the deduction may be larger if the value of the property has appreciated in the interim. Thus, the employer's tax treatment may vary depending on whether the employee makes the section 83(b) election.\textsuperscript{51} In addition, the employer may have non-tax reasons to care about whether the employee makes the election. For example, the employee's decision about whether to make the election may give the employer valuable information regarding the employee's expectation about the likely change in value of the property during the restriction period or regarding the employee's expectation that the restrictions will lapse without forfeiture.\textsuperscript{52}

Given the impact of the election on the employer, the employer may want to negotiate with the employee about whether the section 83(b) election will be made.\textsuperscript{53} For example, the agreement that grants the restricted property to the employee may contain a provision obligating the employee to make the election, prohibiting the employee from making the election, or requiring that the employee obtain the employer's consent

\textsuperscript{49} This assumes that the compensation would be deductible under section 162.

\textsuperscript{50} I.R.C. § 83(h).

\textsuperscript{51} But see Knoll, supra note 48, at 727–29, 736 (concluding that, under certain assumptions, “the employee's 83(b) election has no impact on the employer because the employer can neutralize the effect of the 83(b) election by using its tax savings to purchase shares”). Nevertheless, an employer may also care about an employee’s decision about whether to make the election for tax reasons if the employer is not able to make itself indifferent to the timing of the tax benefit. Jennifer L. Blouin & Mary Ellen Carter, The Economics of Restricted Stock and the Section 83(b) Election 8 (Feb. 2010) (unpublished article), available at http://ssrn.com/abstract=1561923.

\textsuperscript{52} This could be particularly valuable if the forfeiture restriction is tied to the employee's tenure with the firm. If the employee refuses to make the election, this may indicate the employee does not expect to stay with the firm for the entire tenure period.

\textsuperscript{53} See Knoll, supra note 48, at 725 (“emphasiz[ing] a joint tax planning approach" between the employer and the employee).
before making the election. Absent such an agreement, the employer generally lacks the power to decide whether the election is made. Regardless of whether the employee makes the election decision completely unilaterally or whether the employer has negotiated for some ability to participate in the election decision, the employee must provide a copy of the section 83(b) election to the employer.

C. Corporate Acquisition Elections

In addition, three major tax elections can serve as focal points for negotiation among parties to corporate acquisitions. Specifically, when most or all of the stock of a target corporation is acquired, one or more of the parties involved in the transaction may be able to make an election that causes the actual stock acquisition to be treated as a deemed asset acquisition for tax purposes. While conceptually similar, the three elections (the "regular" section 338 election, the section 338(h)(10) election, and the section 336(e) election) differ in several respects, including with respect to the transactions to which these elections apply, with respect to which party or parties have the power to make the elections, and with respect to the tax consequences (and hence the desirability) of making the elections. These differences affect the incentives that the various parties have with respect to entering into negotiations with the other parties about whether the election will be made.

Briefly, a regular section 338 election, which is available when a single corporate buyer purchases at least 80% of the vote and value of the stock of a target corporation within a twelve-month period (a "qualified stock acquisition")

54 See Blouin & Carter, supra note 51 at 2, 31–32 (finding that some public firms either require or prohibit a section 83(b) election for property granted in connection with the provision of services).
56 I.R.C. § 338(a), (g). Elections made pursuant section 338(a), but not pursuant to the special rule in section 338(h)(10), are described herein as "regular" section 338 elections; this distinguishes such elections from those made pursuant to section 338(h)(10). See generally MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 205–06 (2010) (using this terminology).
57 I.R.C. § 338(h)(10).
59 The acquisition must involve at least 80% of the total voting power of the target corporation stock and at least 80% of the total value of the target corporation stock. I.R.C. §§ 338(d),(3), 1504(a)(2). Section 1504 provides some special rules for determining whether the 80% vote and value rule has been satisfied. These rules also apply for purposes of...
purchase" or "QSP"), can be made unilaterally by the buyer corporation. The election generally adversely affects the tax treatment of the buyer, while the sellers are generally indifferent to whether the election is made. In limited circumstances (e.g., where the target corporation is a foreign corporation), however, a regular section 338 election can confer tax benefits on the buyer while adversely affecting determining whether this threshold has been met. See, e.g., I.R.C. § 1504(a)(4) (providing that certain debt-like preferred stock is disregarded for purposes of the section 1504(a)(2) determination).

60 I.R.C. § 338(a); see also I.R.C. § 338(h)(3) (defining purchase). With a regular section 338 election, the sellers can be individuals, corporations, partnerships, others, or some combination of the above. This is a key difference from transactions where a section 338(h)(10) election can be made. See infra note 66 and accompanying text.

61 I.R.C. § 338(a). The seller(s) need not consent to the making of the election unless the parties' contract provides that the sellers will have a voice in the decision. For example, the parties could include a provision in the acquisition agreement pursuant to which the buyer corporation agrees not to make the regular section 338 election without the consent of the sellers.

62 If a regular section 338 election is made, then an extra layer of current tax - corporate level tax on the target corporation — is triggered as a result of the deemed asset sale. I.R.C. § 338(a); Treas. Reg. § 1.338-4 (2001). The economic burden of that additional tax generally falls on the buyer corporation, unless the parties negotiate and agree to shift all or part of that burden to the sellers. Treas. Reg. §§ 1.338-10(a) (2007), 1.338-1(b)(3)(i) (2009). Such a shift could occur, for example, via a reduction in the purchase price for the stock or via a provision in the acquisition agreement pursuant to which the sellers agree to indemnify the buyer corporation for pre-closing taxes of the target corporation. Of course, the election generally results in a step-up in the basis of the target corporation's assets. Treas. Reg. § 1.338-5 (2001). Paying tax now in exchange for extra basis to be used later is generally a disadvantageous trade because the taxpayer foregoes the time value of money used to pay the current tax.

63 The target corporation shareholders will recognize gain or loss from the actual sale of their target corporation stock. This is generally true regardless of whether a regular section 338 election is made.

64 If the target corporation is a foreign corporation, then the regular section 338 election can be beneficial for the buyer corporation because, for example, the regular section 338 election steps up the target corporation's basis in its assets and wipes out the foreign target corporation's historic earnings & profits (E&P), thereby potentially reducing the buyer
some sellers, in which case the parties may have an incentive to bargain about whether the election will be made.

The section 338(h)(10) election, which is available when a single corporate buyer makes a QSP of the stock of a target corporation that is a member of the consolidated or affiliated group of the target’s parent corporation (i.e., the seller corporation), is made jointly by the buyer corporation and the seller corporation. The election affects the tax treatment of both the buyer and the seller. The buyer generally obtains tax benefits from the election if the assets of the target corporation have

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65 If a regular section 338 election is made for a target corporation that is a controlled foreign corporation (CFC), U.S. shareholders of the CFC could, among other possible consequences, have increased taxation under subpart F. This could occur, for example, if the deemed asset sale gave rise to subpart F income while the actual stock sale would not have given rise to such income. See Treas. Reg. § 1.338-9(f), Ex. 3 (2001); see also Kimberly S. Blanchard, Cross-Border Acquisition Patterns Implicating Section 338: Recommendations for Reform, in 843 PRACTISING LAW INSTITUTE: TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 607, 625 (2008) ("If old [CFC target corporation’s] deemed sale of assets gives rise to subpart F income, that subpart F income will be taxable to any selling shareholders that are U.S. shareholders of [the CFC target corporation]. Moreover, if the deemed sale generates E&P, that additional E&P will support an increased subpart F inclusion (see section 952(c)) and/or an increased section 1248 pick-up (section 1248(d)(1) prevents double counting."); DOLAN, supra note 64, at ¶ 2.03[2][b] (describing the possible tax consequences to U.S. shareholders who sell stock in a CFC where a regular section 338 election is made); KUNTZ & PERONI, supra note 64, at ¶ B6.03[11].

In acknowledgement of the risk that selling shareholders could be liable for increased tax and to help ensure that the shareholders of the target corporation correctly report their U.S. federal income tax burden, the Treasury Regulations provide that a buyer corporation that makes a regular section 338 election with respect to a CFC must provide notice to the U.S. persons that are shareholders of the target if the regular section 338 election will affect the U.S. federal income tax treatment of such U.S. persons. Treas. Reg. § 1.338-2(e)(4) (2001). This notice requirement also applies if the target corporation is a passive foreign investment company. Id. Failure to provide such notice in a timely fashion may invalidate the regular section 338 election. Treas. Reg. § 1.338-2(e)(4)(v), (vi) (2001).

66 Treas. Reg. § 1.338(h)(10)-1(c) (2007). A section 338(h)(10) election may also be made with respect to a target corporation that is an S corporation. Id. For simplicity, however, this article will generally focus on situations where the target corporation is a member of the selling parent corporation’s consolidated group.

appreciated, and the election often changes the amount of gain recognized by the seller (which may increase or decrease the tax burden depending on the circumstances). Evidence suggests that buyers have been willing to share part of the value of their tax benefits with sellers by increasing the purchase price for transactions where a section 338(h)(10) election will be made. In limited circumstances (e.g., where the assets of the target

A section 338(h)(10) election generally results in a step-up in the basis of the assets of the target corporation (which, at the end of the transaction, is owned by the buyer corporation). Treas. Reg. § 1.338(h)(10)-1(d)(3) (2007). In contrast to the regular section 338 election that results in the recognition of tax on the deemed asset sale in addition to the recognition of tax on the actual stock sale, the section 338(h)(10) election results in the recognition of tax on the deemed asset sale generally in lieu of the recognition of tax on the actual stock sale. Thus, with a section 338(h)(10) election, the target corporation is able to get a stepped-up basis in its assets with the imposition of only one level of current tax.

The stepped-up basis that the target corporation takes in its assets ensures that only two layers of tax will ultimately be imposed on the sale of the target’s business — corporate level tax upon the deemed sale of the target’s corporate assets, and shareholder level tax when the parent corporation ultimately distributes the sales proceeds out to its shareholders. Without the stepped-up basis from the section 338(h)(10) election, there would be an additional layer of tax lurking. In addition to the corporate level tax on the parent corporation upon the sale of the target stock and the shareholder level tax imposed when the parent corporation ultimately distributes the sales proceeds out to its shareholders, the target corporation would still have its historic basis in its assets. This means there could be an additional layer of corporate level tax imposed on the target if and when the target later disposes of its assets.

See generally W. Eugene Seago & Reza Barkhi, In the Process of Preventing Triple Taxation of a Subsidiary’s Income, Congress Created a Great Indoor Game, 109 TAX NOTES 1081, 1081 (2005). The tax advantage of the section 338(h)(10) election thus inures to the benefit of the buyer corporation, in that the target corporation (owned by the buyer corporation post-acquisition) has stepped-up basis in its assets and will not be subject to additional tax on appreciation that accrued pre-acquisition.

Without the section 338(h)(10) election, the seller’s recognized gain or loss is determined based on the seller’s actual stock sale. If a section 338(h)(10) election is made, the actual sale of target corporation stock is disregarded for tax purposes, and instead, the gain or loss recognized on the transaction is determined based on the target corporation’s deemed sale of its assets. I.R.C. § 338(h)(10)(A); Treas. Reg. § 1.338(h)(10)-1(d) (2007). These amounts of gain can differ, depending on the difference between the seller corporation’s basis in its target corporation stock and the target corporation’s basis in its assets, among other things. Note that where the target corporation is a member of parent corporation’s consolidated group before the acquisition, the parent corporation (the seller) generally bears the economic burden of the tax on the deemed asset sale, at least in the absence of an agreement between the parties to shift that burden. Treas. Reg. § 1.338(h)(10)-1(d)(3), (7) (2007).

corporation have declined in value), the section 338(h)(10) election may disadvantage the buyer while benefiting the seller,71 in which case it may be in the buyer’s interests to negotiate with the seller as to whether the election will be made.

The section 336(e) election,72 which is available when a single corporation disposes73 of at least 80% of the vote and value of the stock of a target corporate subsidiary within a 12 month period (a “qualified stock disposition” or “QSD”),74 creates incentives for bargaining that are

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71 This could happen if asset acquisition treatment would result in a step down in the target corporation’s basis in its assets (a disadvantage for the buyer), while asset acquisition treatment reduced the total amount of gain recognized by the seller on the transaction (a benefit for the seller).

72 Section 336(e), which empowers the Secretary to promulgate regulations allowing for an election to treat the disposition of the stock of a subsidiary corporation as the disposition of the subsidiary corporation’s assets, was enacted in 1986, but such regulations were proposed only in 2008 and have not yet been finalized. Prop. Treas. Reg. §§ 1.336-5, 73 Fed. Reg. 49965-02 (Aug. 25, 2008). Unless otherwise stated, the analysis herein assumes that the regulations will be finalized as proposed.


74 Id. at § 1.336-1(b)(5). Note that there can be a single acquirer or multiple acquirers of the target corporation stock, and that the acquirer(s) can be individuals, corporations, partnerships, others, or a combination. Id. at §§ 1.336-1(b)(2), (5); see also I.R.C. § 7701(a) (defining “person”). If a stock disposition would qualify as both a QSP for section 338 purposes and a QSD for section 336 purposes, it will generally be treated as a QSP and not as a QSD. Prop. Treas. Reg. § 1.336-1(b)(5)(ii), 73 Fed. Reg. 49965-02 (Aug. 25, 2008).
substantially the same as those described for the section 338(h)(10) election.\textsuperscript{75} Unlike the section 338(h)(10) election, however, which is made jointly by the buyer and seller, the section 336(e) election would be made unilaterally by the corporation that is disposing of the target corporation stock.\textsuperscript{76} In proposing that the section 336(e) election be made unilaterally.

\textsuperscript{75} Like the section 338(h)(10) election, a section 336(e) election “avoid[s] the triple tax that would arise in a situation where the stock of a target corporation is sold, exchanged or distributed and both the target corporation’s assets and its shares have increased in value.” New York State Bar Ass’n, \textit{Report on Proposed Regulations Implementing Section 336(e)} 2009 TNT 1-21, at 1–2 (Dec. 31, 2008); \textit{cf. supra} note 68 (discussing the possibility of triple taxation in the absence of a section 338(h)(10) election). Further, where the assets of the target corporation have appreciated, a section 336(e) election benefits the acquirers because the election generally results in a step-up in the basis of the assets of the target corporation (which, at the end of the transaction, is owned by the buyer corporation). Prop. Treas. Reg. \textsection 1.336-2(b)(1)(ii), 73 Fed. Reg. 49965-02 (Aug. 25, 2008). On the other hand, acquirers may not want the election to be made if the target corporation’s assets have declined in value; this is because a section 336(e) election would result in stepped-down basis in the asset.

For the corporation disposing of the target corporation stock, a section 336(e) election may change the amount of gain or loss recognized. This is because section 336(e) election causes the amount of gain/loss recognized to be determined based on the deemed asset disposition rather than based on the actual disposition of target corporation stock, provided that, where an asset disposition is deemed to occur, the target corporation will be barred from recognizing certain losses. Prop. Treas. Reg. \textsection 1.336-2(b)(1)(i), (iii), 73 Fed. Reg. 49965-02 (Aug. 25, 2008). \textit{But see, e.g.}, New York State Bar Ass’n, \textit{supra} at 2, 27–36 (criticizing this limitation on the ability of the target corporation to recognize losses and suggesting a change to this limitation). Note that, if the target corporation filed a consolidated return with its parent corporation prior to the transaction, then the selling parent corporation will generally bear the economic burden of any gain or loss recognized as a result of the deemed asset disposition. Thus, if the election will reduce the amount of gain recognized or increase the amount of loss recognized, then the seller will generally benefit from the election; if the election will increase the amount of gain recognized or decrease the amount of loss recognized, then the seller will generally not benefit from the election.

Ultimately, particularly where the acquirers would benefit from the election and the selling parent corporation might not benefit from the election, the acquirers may have an incentive to negotiate with the seller corporation in order to ensure that the election is made. Similarly, if the selling parent corporation would benefit from the election and the acquirer would not, the parties may also have an incentive to negotiate about whether the election will be made.

\textsuperscript{76} Prop. Treas. Reg. \textsection 1.336-2(h), 73 Fed. Reg. 49965-02 (Aug. 25, 2008). Commentators have criticized this unilateral election as contrary to legislative intent. \textit{See, e.g.}, Letter from Wendy Richards, 2008 TNT 232-66 (Nov. 24, 2008) (suggesting that the section 336(e) election should generally be made jointly); New York State Bar Ass’n \textit{supra} note 75, at 3, 101–09 (“At least where the seller and the target corporation do not file a consolidated return, the Section 336(e) election should be made by the seller and the target corporation jointly in a time and manner generally consistent with what Section 338
by the party disposing of the target corporation stock, the preamble to the proposed regulations explicitly assumes that the acquirers will be able to protect their own interests by bargaining with the party disposing of the target corporation stock.\footnote{See 73 Fed. Reg. 49965-02, 49970 (Aug. 25, 2008) ("[T]he distributees’ interests should generally be protected because of the distributing corporation’s fiduciary responsibilities to its shareholders. In the case of a sale or exchange, the purchasers should be able to protect their interests in any purchase contract.").}

III. COASE AND EFFECTIVE TAX BARGAINING

All of the forgoing explicit elections create opportunities for bargaining among private parties, and the details of these elections, discussed above, create the parameters and incentives for the bargaining. Drawing on the law and economics literature regarding private bargaining, this section will discuss the ability of these parties to reach efficient bargains among themselves about whether to make a tax election. Specifically, this section will apply the Coase Theorem to this tax bargaining, will discuss impediments to effective bargaining, and will argue that tax policymakers should be concerned about these impediments.

A. The Coasean Approach

The Coase Theorem postulates that “in a regime of zero transaction costs, . . . negotiations between the parties would lead to those arrangements being made which would maximize wealth and this irrespective of the initial assignment of rights.”\footnote{R. H. Coase, The Institutional Structure of Production, 82 AM. ECON. REV. 713, 717 (1992) (accepting George Stigler’s formulation of the theorem that bears Coase’s name); see R. H. Coase, The Problem of Social Cost, 3 J.L. & ECON. 1 (1960) [hereinafter Coase, Social Cost].} As applied to the types of explicit tax elections described above,\footnote{See supra Part II.} this would mean that, in the absence of transactions costs, rational\footnote{Unless otherwise stated, this article assumes that taxpayers measure utility in dollars.} taxpayers would bargain effectively and reach an agreement about whether to make the election based on the choice that best reduces their total aggregate tax burden. This would be true provides.\footnote{See also infra Part V.C (arguing that the section 336(e) election should be made jointly). While neither the target corporation nor the parties acquiring the target corporation stock are required to consent to the election, the electing party must provide a copy of the election to the target corporation. Prop. Treas. Reg. § 1.336-2(h), 73 Fed. Reg. 49965-02 (Aug. 25, 2008).}
regardless of the assignment of initial rights — that is, regardless of how the power to make the election is allocated among the taxpayers and regardless of the default rule.

The agreement to exercise the election in a way that best minimizes the parties' aggregate tax burden would be efficient, at least as between the parties to the agreement.\textsuperscript{81} The tax-reducing agreement between the parties might be efficient (as between the parties) in the Pareto optimal sense,\textsuperscript{82} where the parties' individual preferences\textsuperscript{83} are aligned. For example, a section 338(h)(10) election in connection with the acquisition of a target corporation with appreciated assets might make the buyer corporation better off because the target corporation gets a stepped-up basis in its assets. At the same time, the election also might make the seller corporation better off if less total gain would be recognized (e.g., if the target corporation's basis in its assets significantly exceeds the seller corporation's basis in its target corporation stock), while no party to the agreement is made worse off. Even if an agreement to make an election is not Pareto optimal as between the directly affected taxpayers, the election may be efficient (again, as between the parties) in the Kaldor-Hicks sense.\textsuperscript{84} For example, an agreement to allow a noncustodial parent (rather than the custodial parent) to take the dependency exemption for a child likely makes the custodial parent worse off (because she must now pay more tax). However, the noncustodial parent may be so much better off (because he is in a higher tax bracket, so the value of the dependency exemption to him is higher) that he may be willing to compensate the custodial parent for her increased tax bill, thereby

\textsuperscript{81} Of course, an agreement that minimizes the aggregate tax burden of the contracting parties reduces revenue to the fisc. This may or may not be efficient overall depending on whether the private parties can put the funds to more productive use than the government could have. See infra notes 82 and 84, 179. Part III.C will discuss the impact of these tax-minimizing agreements on the fisc and the taxpayers who are not party to the agreement.

\textsuperscript{82} See ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 16–17, 48 (4th ed. 2004). This could be described, at best, as weakly Pareto efficient because this example does not take into account the impact of the election on the fisc. Of course, to the extent that taxpayers bargain to make an election that reduces their aggregate tax burden, the fisc is negatively impacted, thereby reducing funds available for the general public. Taking the general public into account, the election described in the text accompanying this footnote could not be Pareto optimal. At best, it could be efficient in the Kaldor-Hicks sense, assuming that the parties to the transaction are made so much better off by their reduced tax burden that they could compensate the general public for the loss suffered.

\textsuperscript{83} When I say "individual preference," I mean the particular taxpayer's preference setting aside the possibility of bargaining and in the absence of any compensating payment.

\textsuperscript{84} COOTER & ULEN, supra note 82. This election may or may not be efficient in the Kaldor-Hicks sense if, in addition to taking account of the impact of the election on the directly affected taxpayers, the analysis also takes the general public into account.
ensuring that she is not worse off on net.\(^8\)

In the absence of transaction costs, rational taxpayers should be able to reach these efficient agreements about whether to make elections without regard to whether the tax law provides that the election is exercised unilaterally by one taxpayer or the other, or whether the tax law requires joint action, and without regard to the default tax treatment that would apply in the absence of the election. Of course, Coase stresses that transaction costs are often large and must be taken into account.\(^8\) Tax planning via explicit elections, however, may have lower transaction costs than other types of tax planning. This is because explicit elections, by definition, do not require the parties to alter their non-tax legal or economic arrangements in order to change their tax treatment; the parties merely need to fill out a form and submit the form to the Service in order to choose their desired tax treatment.\(^8\) Nevertheless, there may be significant impediments to parties’ abilities to exercise the election in the way that best minimizes their overall tax burden.

\section*{B. Impediments to Effective Bargaining}

Transaction costs, cognitive biases, and other irrational behavior may impede taxpayers’ abilities to reach tax-minimizing agreements about how to exercise tax elections. The impact of these impediments varies based on the context for the election. As will be discussed further below, the impediments are often (but not always) quite different in the divorce context\(^8\) than they are in the corporate acquisition context, with the employment context generally providing an example in the middle.

\subsection*{1. Transaction Costs}

Transaction costs can be divided functionally into “information costs,” “get-together costs,” and “decision and execution costs.”\(^8\) Each will be

\(^8\) The release of the dependency exemption cannot be explicitly contingent upon increased child support payments. However, a custodial parent can effectively make the release of the dependency exemption contingent on the payment of additional support by declining to provide the release until after the additional support is paid.

\(^8\) See Coase, Social Cost, supra note 78, at 15–19.

\(^8\) See Field, supra note 11, at 22 (defining explicit elections).

\(^8\) For an interesting discussion about the bargaining dynamic in the context of divorce, see, for example, Zelder, supra note 22.

\(^8\) Robert C. Ellickson, The Case for Coase and Against “Coaseanism”, 99 Yale L.J. 611, 615 (1989). These categories overlap to some degree. Further, there are other ways to categorize transaction costs, including chronologically, but I think the functional division is
discussed in turn.

a. Information Costs

Asymmetric and/or imperfect information may pose a significant barrier to bargaining about whether a tax election should be made. Information costs include the cost of acquiring information about the law, information about the facts, and information about the value of the election to the affected parties.

(1) Information About the Law

Taxpayers must be familiar enough with the tax law to know about the availability of the election and about the election’s tax consequences. Taxpayers often differ in their level of sophistication and knowledge of the tax law, so it is likely that they will need good tax advisors to inform them about the availability of the election (and hence the opportunity for bargaining).

Taxpayers may have high barriers to knowledge about the law, particularly in the context of divorce. Not all divorce lawyers are sophisticated tax planners, so they may not be as able to advise the divorcing spouses about the elections regarding the dependency exemption and alimony that could provide for opportunities to minimize taxes through private bargaining. Moreover, there may be a disparity between the divorcing spouses as to their relative financial sophistication and access to tax-savvy advisors, and divorcing spouses are increasingly representing themselves. Further, opportunities to engage in tax minimizing bargaining

most useful for understanding how transaction costs can impede bargaining in the tax election context.

90 See generally Herbert Hovenkamp, The Coase Theorem and Arthur Cecil Pigou, 51 Ariz. L. Rev. 633, 638 (2009) ("The literature on the Coase Theorem continues to treat imperfect information as one of the more serious causes of high transaction costs that hinder bargaining."); Ellickson, supra note 89, at 615.


92 See Judith G. McMullen & Debra Oswald, Why Do We Need a Lawyer?: An Empirical Study of Divorce Cases, 12 J.L. & Fam. Stud. 57, 57 (2010), available at http://ssrn.com/abstract=1580243. McMullen and Oswald do note that divorcing spouses "tended to employ attorneys when certain factors, such as minor children, . . . or higher husband’s income, made the divorce more complex." Id. at 59. Thus, divorcing spouses are
may arise years after the divorce is finalized (e.g., if a change in circumstances might make it beneficial for them to switch the allocation of the dependency exemption); the divorced spouses may not have any tax advisor at that time to make them aware of the election and the bargaining opportunity.

In contrast, where taxpayers tend to be relatively sophisticated and well-advised, as in the context of large corporate acquisitions where a regular section 338 election or a section 338(h)(10) election might be made, taxpayers are likely to be able to obtain the necessary information about the tax law from their tax advisors, albeit at a high hourly billing rate. Similarly, sophisticated tax advisors may also be able to inform their corporate clients about the availability and consequences of a section 336(e) election. But, given that section 336(e) has effectively been nonoperational for many years in the absence of implementing regulations (which have only been recently proposed), clients and even savvy lawyers may have less familiarity with this election.

(2) Information about the Facts

Taxpayers (and their advisors) may also lack the factual information to realize that the election could be relevant to the situation. Without this information, they may not even realize that there is an opportunity to bargain about whether an election will be made.

In the divorce and employment contexts, knowledge of the facts may not be particularly problematic. Divorcing spouses know that they are getting divorced.\textsuperscript{93} Similarly, both the employer and the employee generally know if restricted property is being transferred by the employer to the employee in compensation for services.

In contrast, in multi-step corporate acquisitions, some small parties may lack information about what larger set of related transactions might be occurring. For example, in a QSP for which a regular section 338 election can be made, the buyer corporation may purchase the target stock from a large number of disparate sellers in a series of separate transactions over a twelve-month period.\textsuperscript{94} Thus, while the buyer corporation may have a plan

\textsuperscript{93} They may not know the tax law implications of these facts, but surely they know the facts.

\textsuperscript{94} \textit{See supra} notes 59–65 and accompanying text.
to acquire more than 80% of the stock of the target corporation, each selling shareholder, particularly the shareholders who sell early on, may have no idea that the sale of their stock is part of a transaction to which a regular section 338 election could apply. Where the target corporation is a foreign corporation, the selling shareholders that would be affected by the regular section 338 election will ultimately receive notice from the buyer corporation if there has been an election, but this information will only be received after the election has been made, and thus after the bargaining opportunity has likely passed.

Similarly, in a QSD for which a section 336(e) election can be made, the stock disposition can be made to a huge number of disparate parties in a series of separate transactions over a twelve-month period. Thus, an individual shareholder who acquires a small amount of the target corporation stock may not be aware of the overall disposition plan, so he may not even realize that a section 336(e) election is a possibility, even if he is aware of the law. As a result, he may unintentionally forego the opportunity to negotiate about whether the election will be made.

(3) Valuation Information

Additionally, in order to assess the potential value of bargaining about and making an election, taxpayers need to have sufficient information both about their own tax situation and about the tax situation of the other party affected by the election. This may require taxpayers to estimate their own tax and financial situation for the current and future years.

For example, in the divorce context, each taxpayer must estimate his or her expected future income and tax burden in order to value the potential benefit of the available elections. The difficulty of making this estimate depends on the taxpayer’s individual circumstances (e.g., does the taxpayer have a steady salaried job or is the taxpayer self-employed or compensated on commission, such that the taxpayer’s income may vary markedly year to year?). That said, in the divorce context, the parties, if they cooperate, generally can switch their choices from year to year to accommodate changing circumstances. In the employment context, the employee must project the extent to which the transferred property will increase (or decrease) in value and must assess the likelihood that he will ultimately receive the property without forfeiture. Again, these projections may be difficult depending on the circumstances, and there is significant pressure on getting these projections right given that the section 83(b) election

95 See supra notes 72–77 and accompanying text.
generally cannot be changed in the future if the projections turn out to be incorrect.

Valuation can also be an issue in the context of one of the corporate acquisition elections, where a party disposing of corporate stock will need to be able to compare the tax cost of the transaction if an election is made to the tax cost of the transaction if the election is not made. This may be fairly easy since taxpayers should know their stock basis and corporations should know their bases in their assets; nevertheless, someone must be paid to collect this information and perform these calculations. Value estimation may be slightly more difficult for the acquirer in a corporate acquisition; an acquirer will need to have a sense about future income projections in order to estimate how valuable any stepped-up basis (and hence, increased depreciation deductions) will be.

In addition to the foregoing, assuming that each taxpayer can determine the value of the election to him/her/itself, the taxpayer must also attempt to estimate the value (or cost) of the election to the other party affected by the election. That task may be hard without the revelation of private information about the tax and financial status of the other party.

b. Get-Together Costs

Transaction costs can also include "get-together costs," which Professor Robert Ellickson defines as "the burdens of arranging physical and electronic connections among transacting parties. They include the costs of establishing lines of communications, setting up meetings, and transporting parties and goods."96 The magnitude of these costs likely depends on whether the parties are already engaged in bargaining, how many parties are involved, and how many separate transactions and separate elections are involved.

In the context of bargaining about tax elections, get-together costs may be low if the parties are already negotiating. So, for example, where more than 80% of the stock of a target corporation is being acquired, the seller(s) and the acquirer(s) are likely to be engaged in extensive negotiations about various aspects of the transaction.97 Thus, there should only be a marginal additional cost for getting together to negotiate about whether to make a section 338(h)(10) election, given that there is generally a single corporate purchaser buying more than 80% of the stock from a single corporate

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96 Ellickson, supra note 89.
97 See, e.g., Ginsburg & Levin, supra note 56, at ¶¶ 2100–2600 (providing sample acquisition agreements).
seller. Similarly, when an employer is granting restricted property to an employee in connection with the performance of services, the employer and employee are likely bargaining about the amount of property, the restrictions to which the property is subject, and the conditions of employment, among other things. Thus, there may be relatively low additional cost for the parties to get together to discuss whether a section 83(b) election will be made.

Get-together costs may increase somewhat as the number of parties involved in the transaction increases. For example, in a transaction to which a regular section 338 election may apply, there may be multiple sellers of target corporation stock, and in a transaction to which a section 336(e) election may apply, there may be multiple buyers/acquirers of target corporation stock. Of course, if the purchases from multiple sellers (or the sales to multiple buyers) occur as part of a single integrated transaction, the multiple sellers (or multiple buyers, as the case may be) are generally represented at the negotiating table by agents acting on behalf of all of them (e.g., officers of the target company or representatives of the purchasing group). Just as those agents negotiate representations, warranties, and covenants, etc., on behalf of the multiple sellers (or multiple buyers), those agents should be able to represent the interests of their principals in the negotiation about whether an election should be made. As a result, the increase in the number of parties involved in the transaction may not significantly increase the get-together costs associated with negotiating over whether a corporate acquisition election will be made.

Get-together costs may be increasingly problematic when there are multiple separate transactions. Then, taxpayers must get together to negotiate when they might not otherwise have already been engaged in bargaining with each other. For example, consider a single corporation that purchases ten percent of the target corporation stock from each of ten different shareholders in separate transactions over a period of ten months; the buyer corporation could make a regular section 338 election in connection with this acquisition. However, although the buyer corporation negotiates with each individual seller, the separate sellers are not represented by a single agent in the negotiations and the sellers may not be cooperating with each other in their negotiations with the buyer corporation. Thus, there may be significant costs associated with getting

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98 See supra Part II.C.
99 See supra Part II.C.
100 See supra Part II.C.
101 But see infra Part III.B.1.c (noting that execution costs may increase significantly).
102 Even if the different sellers are informed about the series of transactions, there is
all of the sellers together to negotiate with the buyer about whether the regular section 338 election will be made.

Get-together may be most costly where the election is made not just once (as with the corporate acquisition elections), but potentially every year (as with elections in the divorce context) when the parties might not otherwise be negotiating each year. Of course, divorcing spouses are likely to be engaged in negotiation when they first get divorced. At that time, they can reach an agreement about how they want alimony to be treated for tax purposes and about how the dependency exemption will be allocated. To the extent that their circumstances change over time, however, and the original agreement does not best minimize their aggregate taxes, the former spouses would need to reconvene in order to agree to change their election. \(^{103}\) This renegotiation may need to occur at a time when the parties might not otherwise be in communication. This could create potentially significant get-together costs even if the parties are completely rational, which they often are not, particularly in situations like divorce that can be fraught with emotion and complex interpersonal power dynamics.

c. Decision & Execution Costs

Parties must also decide how they wish to proceed, and they must formalize their agreement. \(^{104}\) If the parties have sufficient information, the costs of deciding what to do may be minimal. This is likely to be true even if “a transacting party is either a nonhierarchical group of two or more persons who must coordinate together or a hierarchical organization with a multi-person decision-making structure[.]\(^{105}\)” assuming that the parties are acting rationally and the value of the election can be reduced to a monetary figure.

Execution costs include the costs of documenting the agreement and completing the relevant forms necessary to make the election. \(^{106}\) Documenting the agreement likely entails a relatively minimal cost if the

\(^{103}\) The parties might also need to get together every year if the custodial parent is only willing to release the dependency exemption to the noncustodial parent on a year-by-year basis, in part to give her additional leverage to collect child support payments. See Larry Maples, Divorce Agreement Language, 198 J. Of Acct. 25, 29 (2004) (recommending a year-by-year release of the dependency exemption).

\(^{104}\) See Ellickson, supra note 89, at 615 (“Decision and execution costs are the costs, apart from information costs, that parties who have gotten tougher incur to actualize their agreement.”).

\(^{105}\) Id.

\(^{106}\) See id.
parties are already negotiating about other matters; thus, these costs likely mirror get-together costs. Further, the process of making a tax election is relatively straightforward because it generally just involves the completion of a form with basic information about the transaction and the parties. As the number of parties required to sign the election form increases, however, the execution of a tax election can become more complex and thus more costly. This is particularly true if a company representative negotiates and executes the acquisition agreement but the individual shareholders must actually execute the tax election.

2. Cognitive Biases

Even in the absence of transaction costs, taxpayers may not behave perfectly rationally, which may inhibit their abilities to reach tax-minimizing bargains about whether to make elections. Building on the work of cognitive psychologists, behavioral law and economics scholars suggest that analyses of law should take into account the systematic ways in which people deviate from ideal concepts of rational decision-making. These cognitive biases impose “bounds” on rational human behavior and may impede taxpayers from reaching tax-minimizing agreements about whether to make tax elections. Specifically, when trying to bargain about whether to make a tax election, taxpayers could be affected by (a) framing, (b) status quo bias, the endowment effect, and overall “stickiness” of legal entitlements, and (c) anchoring, among other possible cognitive biases.

a. Framing

“Framing refers to the effect whereby the same question or choice set,

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107 See supra Part III.B.1.b.
108 The election forms do vary in complexity. See, e.g., PRACTITIONERS PUBL’G CO., TAX ELECTIONS DESKBOOK (11th ed. 2005) (detailing the technical requirements for completing and filing a variety of elections).
109 For example, this could occur if an S corporation is acquired in a reverse triangular merger. A representative of the S corporation would sign the acquisition agreement on behalf of the company that is participating in the merger. However, in order to make a section 338(h)(10) election with respect to that acquisition, each individual S corporation shareholder must sign the election form.
described differently, can lead to different answers." Concerns about framing highlight the importance of both the allocation of the power to make the tax election and the default rule that is applicable in the absence of an election.

Specifically, a joint election frames the choice as a joint decision that requires cooperation. For example, the joint action required to opt out of the default treatment of alimony requires both former spouses to consent together. In contrast, a unilateral election frames the question as a choice that belongs solely to the taxpayer who is empowered by the tax law to make the election, thereby altering the power dynamic between the taxpayers. For example, in the section 83(b) election, the tax law vests in the employee, alone, the power to choose how his receipt of restricted property will be treated for tax purposes. This frames the choice as belonging to the employee, even though the employer may have an interest in participating in joint decision-making. Even corporate transactions may be influenced by these cognitive biases, although possibly to a lesser extent than individuals. For example, a section 338(h)(10) election is designed as a joint election and is thus framed as requiring cooperation; in contrast a regular section 338 election can be made unilaterally by the buyer corporation, which frames the choice as belonging to the buyer and not the seller(s). The framing effect, however, may not be particularly powerful in corporate acquisition elections given the likely involvement of sophisticated tax planners, who may be able to help businesspeople overcome this framing effect.

Additionally, default rules frame each tax election in a particular way. For example, the election regarding the tax treatment of alimony effectively

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113 See supra Part II.A.1. The framing of the dependency exemption presents an interesting hybrid case. The custodial parent is vested with the unilateral power to release the dependency exemption to the noncustodial parent. Even though joint action is required in that the noncustodial parent must attach the release form to his tax return, the fact that the tax law gives the custodial parent sole power to keep or release the dependency exemption frames the choice as belonging primarily to the custodial parent. See supra Part II.A.2.

114 See Brett H. McDonnell, Sticky Defaults and Altering Rules in Corporate Law, 60 SMU L. REV. 383, 393–94 (2007) (discussing how the power dynamic between parties can be affected by the rules that affect the way in which parties can opt out of a default rule).

115 See Knoll, supra note 48, at 726.

currently asks the payor whether (and in exchange for how much) he is willing to “give up” the deduction that he would otherwise get for the payment of alimony. The payor might respond differently if the default rule was reversed, such that the election would effectively ask the payor if (and in exchange for how much) he would be willing to pay in order to receive a deduction for alimony payments that would otherwise be nondeductible.

b. Status Quo Bias, the Endowment Effect, & “Stickiness”

Another bias that is commonly discussed in the literature is the “status quo bias,” which suggests “individuals tend to prefer the present state of the world to alternative states, all other things being equal.” This concept highlights the importance of the choice of default rule. To the extent that parties are affected by a status quo bias, the tax treatment specified by a default rule may be entrenched, even if the parties might be able to agree to elect an alternative that better minimizes their overall tax burden. For this reason and many others, a default rule may be “sticky.”

A related, though slightly narrower, concept is the “endowment effect,” that is, “the principal that people tend to value goods more when they own them than when they do not.” Taxpayers affected by the endowment effect may value a particular tax entitlement, such as the dependency exemption, more than its objective fair market value just because of the initial allocation of that entitlement. Further, it is possible that, for example, a custodial parent could equate her initial entitlement to the dependency exemption with her relationship with her child, which might make her disinclined to release the exemption even if the noncustodial parent pays her more than the exemption would otherwise be worth to her. Nevertheless, while the status quo bias may make the default treatment “sticky,” the endowment effect may not have much influence with respect to tax elections, given that these tax bargaining focal point elections are often made by businesspeople acting as agents for others and given that

120 Korobkin, supra note 117, at 1279 (citing Jennifer Arlen, Matthew L. Spitzer, & Eric L. Talley, Endowment Effects Within Corporate Agency Relationships, J. LEGAL STUD. 1, 33).
most tax entitlements can be reduced to their monetary values. In contrast, taxpayers who are less sophisticated, less knowledgeable, and less wealthy may be even more susceptible to the variety of issues that lead to stickiness.

Additional issues that are related to (or possibly explanatory of) the endowment effect can also make initial allocations of rights sticky. Specifically, the legal framework can have a signaling or "legitimating effect, carrying important information about what most people are expected to do." Further, stickiness may also be largely a product of procrastination or inertia.

c. Anchoring

The concept of "anchoring" has been described as "the tendency for people to make decisions based on an initial estimate that is later adjusted, but not sufficiently to eliminate the influence of the initial estimate." In particular, this bias may affect taxpayers' decisions with respect to tax elections that can be made year after year in succession, such as the election regarding the allocation of the dependency exemption between divorced parents. Taxpayers may make a tax-minimizing decision regarding the allocation of the dependency exemption in the first year, but they may not accurately take account of changed circumstances in subsequent years in assessing how to allocate the dependency exemption. Thus, they may continue to allocate the dependency exemption in the manner first agreed upon even if that approach is no longer the tax-minimizing decision. Similarly, if a service provider receives restricted property in connection with the performance of services for multiple years in a row, he may decide to make the same decision regarding the section 83(b) election for later property grants as he made with respect to earlier property grants, even if circumstances have changed such that the original choice is not tax-minimizing with respect to the later grants.

121 See Cass Sunstein, Switching the Default Rule, 77 N.Y.U. L. REV. 106, 109 n.10 (2002) (citing Richard Thaler, Quasi-Rational Economics 169, at 176 (1991) for the proposition that "endowment effect might be small or nonexistent ... if legal entitlements are ... akin to money tokens.").


123 Sunstein, supra note 121, at 109.


3. Sheer Irrationality

Even setting aside transaction costs and systemic biases that lead to bounded rationality, there is a risk that parties will behave quite irrationally (assuming again that utility is measured in money) and therefore will not be willing to enter into efficient agreements. This is less likely to be a problem in the context of a corporate acquisition because the value of the election is likely to be reducible to a monetary value and businesspeople are generally focused on the bottom-line. Similarly, in the employment context, employees and employers may be likely to measure utility in money and try to extract as much value as possible from an agreement.

In contrast, divorce can be fraught with great emotion and animus. As a result, divorcing spouses may be more inclined to act in a way that does not maximize his/her economic wealth, as a result of spite, fear, anger or other emotional reaction to the situation. For example, a divorced custodial parent may not be willing to release a dependency exemption and thus may be willing to forego additional compensation, just to prevent the noncustodial spouse from receiving the benefit of using the dependency exemption. Thus, emotion can impede parties from reaching tax-minimizing agreements about whether to make a tax election. This would be irrational if utility is measured in money, but could also be characterized as rational if welfare/utility is measured not in money, but also in emotion.126

C. Impediments to Bargaining Mean that Election Parameters Matter

The various impediments to bargaining described above may prevent some taxpayers from reaching tax-minimizing decisions about tax elections. Of course, when taxpayers do not act to best minimize their taxes, more revenue is collected for the fisc.127 So then, query, why at a time of significant federal budget deficits, policymakers should be concerned about

126 That is, it could be perfectly rational for a custodial parent not to release the dependency exemption if the sum of (1) the monetary value of the exemption to her and (2) the emotional value to her of preventing the noncustodial parent from using the exemption exceeds the value of the dependency exemption to the noncustodial parent. See generally Katharine B. Silbaugh, Money as Emotion in the Distribution of Wealth at Divorce, in RECONCEIVING THE FAMILY 234, 235 (Robin Fretwell Wilson ed., 2006), available at http://ssrn.com/abstract_id=976354 (It is “impossible[e to...] exclude nonfinancial matters from consideration [in dividing wealth accumulated during a marriage], as nonfinancial matters become masked as financial ones.”).

127 See Field, supra note 11, at 31 (“[A] well-advised rational taxpayer will almost always exercise the election in a way that minimizes its tax liability, at the expense of the fisc.”).
taxpayers' inability to reach tax-minimizing agreements.

There are several answers. If policymakers have seen fit to provide a tax election for good reason, then the benefits of that election should be available to all sets of taxpayers and not merely to the sophisticated or well-advised taxpayers who can overcome the impediments to reaching a tax-minimizing bargain. Admittedly, this concern may be less compelling in some contexts (like corporate acquisitions) and more compelling in other contexts (like divorce), especially given the size of the possible disparity in sophistication, financial resources, and power of the relevant parties.

Further, sometimes the ability of taxpayers to bargain is a premise underlying policymakers' decisions about whether to provide an election and what the parameters of the election should be. For example, part of the policy reason for providing the election regarding the tax treatment of alimony was Congress's desire to try to facilitate negotiation among the taxpayers. Similarly, one of the reasons for the provision of the election with respect to the transfer of restricted property in compensation for services was “to add flexibility” for the taxpayers. If the design of the election hinders precisely the negotiation that Congress is trying to facilitate, the election parameters should be revised in order to better achieve the goal. Another example involves one of the corporate acquisition elections — when designing the parameters for the section 336(e) election, policymakers explicitly relied on the ability of the taxpayers to bargain about whether the election will be made. If there was a mistake in the

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128 See id. at 33–66 (describing how explicit elections can be useful as tools in the design of the federal income tax); see also supra notes 16–17. As noted in the introduction, this article generally sets aside the issue of whether the provision of an election is a wise policy choice. Instead, the discussion herein generally accepts the elections as part of the federal income tax system, and seeks to understand, reflect upon, and provide guidance about how to change these elections.

129 This concern is related to the concept of "equal planning under law," as used in the inheritance context. See Mary Louise Fellows, In Search of Donative Intent, 73 IOWA L. REV. 611, 613 (1988).

130 This difference goes more to the magnitude of the concerns and the benefit to be gained from addressing the concerns, than it does to the existence of the concerns.

131 See Moran, supra note 23, at 148 ("Over and over again, the 1984 reform shows: (1) an increased emphasis on couples engaging in tax planning as a unit."); see also, e.g., Patricia G. Lewis & Julie W. Davis, Act Alters Tax Provisions For Divorcing Couples, LEGAL TIMES, Aug. 27, 1984, at 19 (The "Conference Committee provisions appear to be a compromise between eliminating the alimony deduction [altogether] and providing a ‘private ordering’ system as proposed initially by the ABA Tax Section.").


133 See 73 Fed. Reg. 49965-02, 49970 (Aug. 25, 2008) (explaining, in support of the conclusion that the election should be made unilaterally by the corporation disposing of the
assumptions regarding taxpayers' abilities to protect themselves through
effective bargaining, then the election parameters might need to be revised.

Moreover, regardless of whether taxpayers are able to bargain
effectively, the design of the election and the allocation of the initial rights
associated with the election can have distributional consequences. For
example, the fact that a custodial parent has the power to decide whether to
use a dependency exemption or to release it to the noncustodial parent
means that, to get the custodial parent to release the dependency exemption,
the noncustodial parent is likely to have to share with the custodial parent
some of the benefits of the reallocation of that dependency exemption. In
contrast, if the power to decide which parent was entitled to the exemption
was vested solely in the noncustodial parent, the custodial parent would
have little or no leverage to share in part of the value of that exemption.
Similarly, the fact that the default rule for the tax treatment of alimony
favors the payor means that the recipient has little or no leverage to push
the payor to share part of the value of the deduction. In contrast, if the
default rule was reversed (so that the default treatment favored the
recipient), the payor would likely have to share with the recipient some
portion of the tax benefit that the payor would receive from opting out of
target corporation stock, "[i]n the case of a sale or exchange, the purchasers should be able to
protect their interests in any purchase contract").

134 As mentioned earlier, it is possible that parties will reach cooperative bargains
without regard to the underlying legal rules, meaning that the legal parameters for the
election are unlikely to have significant distributional consequences. See Ellickson, supra
note 18. Bargaining without reference to the law, however, is relatively unlikely in the tax
election context because, here, the only thing that is the subject of the bargain is the tax
treatment of a particular action, and tax itself is merely a product of law. That said, divorce is
the likeliest context where parties might coordinate their affairs without regard to the tax
laws that govern their agreement. In such a case, the tax election parameters might not
matter, except to the extent that private agreements may be informed by social norms, and
those social norms may be influenced by the law's allocation of entitlements.

135 In the corporate acquisition context, the fact that the section 338(h)(10) election
must be made jointly means that the buyer and seller generally must share the tax benefits of
the election. In a corporate acquisition, the buyer or the seller may have more leverage
depending on a variety of factors, including the relative size of the buyer and target
("whales" usually have a lot of leverage when buying "minnows"), and the financial statuses
of the corporations (e.g., whether the target corporation is highly sought after by multiple
prospective buyers or whether the target corporation or the seller is in desperate need of
cash), among other issues.

136 That is, the alimony payor can take a deduction for the alimony paid, and the
alimony recipient must include in income the alimony received.

137 That is, the alimony payor would not be able to take a deduction for alimony paid,
and the alimony recipient would be able to exclude the amount received from her income.
the default rule. Whether or not these reflect the desired distribution of the tax benefit associated with the election, the parameters of the election can have distributional consequences.

IV. DESIGNING THE ELECTION PARAMETERS TO FACILITATE TAX BARGAINING

Given the possible welfare, distributional, and administrative consequences of the parameters of tax elections, policymakers should take care in the design of those parameters. The key parameters that set the stage for the private bargaining are (1) the determination of which party or parties has the power to opt out of the default rule, and (2) the choice of default rule.

Of course, these parameters are necessarily intertwined. For example, assume that a tax election employs a default rule that confers a tax benefit on Party A and that opting out would shift the tax benefit to Party B. In that case, if the power to make the election is allocated to B, then B could unilaterally take the tax benefit away from A without compensating A. In contrast, if the power to make the election is allocated to A, then B could only obtain the tax benefit if A agreed to cede the tax benefit, likely in exchange for some compensation. If the default rule in this example is reversed, then the consequences of the allocation of power are also reversed.

This part will analyze and make recommendations with respect to both key parameters. As will be discussed further below, policymakers' abilities to use either or both of these parameters to facilitate bargaining and reduce bargaining costs depend very heavily on two factors — namely, (a) whether, and in what circumstances, the individual preferences of the parties can be systematically identified, and (b) in those situations where

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138 It is possible, and in some cases likely, that the default tax rules are priced into the parties' underlying economic bargain, such that a change in the parameters for an election is likely to have a modest impact. See infra note 217.

139 For example, two commentators have argued that the seller should be entitled to the entire amount of the benefit of the election and thus should be able to make the election unilaterally. Seago & Barkhi, supra note 68, at 1084.

140 There are other parameters too including the details of mechanics for making the election (what has to go on the form and when the form must be submitted to the Service).

141 By this, I mean an affected taxpayer will virtually always prefer one particular tax treatment to another rather than having her individual preference depend largely on facts and circumstances. For example, regardless of the general facts and circumstances, recipients of alimony systematically prefer to exclude the payment from their income rather than to include the payment in their income. Note that even where taxpayers' individual preferences
there are likely to be informational asymmetries between the parties, whether, and in what circumstances, the identity of the less-informed party is reasonably determinable.

Despite the connections between the allocation of power to make an election and the choice of default rule, these parameters merit separate analysis because the parameters can affect the bargaining dynamic in different ways and because one parameter may be more effective than the other for accomplishing policy objectives in particular circumstances.\textsuperscript{142} Thus, Part IV.A addresses the issue of allocation of power to make an election, and then, Part IV.B examines how carefully chosen default rules can help facilitate bargaining and reduce bargaining costs.

Later, Part V will reassemble the parameters and provide recommendations about how to coordinate the parameters.

\textit{A. Allocating the Power to Choose}

Regardless of the default rule that would apply in the absence of an election, this part argues that the tax law should generally require that multiple taxpayers affected by an explicit election make the election jointly rather than unilaterally.\textsuperscript{143} Where an explicit tax election affects multiple taxpayers and thus serves as a focal point for bargaining, joint elections help taxpayers overcome impediments to bargaining. This is particularly true in situations where there are likely to be informational asymmetries between the parties but where it is difficult to determine which party is

\begin{footnote}{142} Further, the allocation of the power to make the election is an issue that is unique to elections that affect \textit{multiple} parties, each of whom could be vested with the power to make the choice. Elections that directly affect \textit{one} taxpayer just involve that taxpayer and the government, in which case that taxpayer is the party that has the power to make the election. In these cases, there is no other directly affected party with whom that power could be shared except for the government, and if the government has the power to make the choice about the tax treatment applicable to the particular situation, there would be no election available.

In contrast, the issue of default rules is relevant to all tax elections, not just those elections that serve as focal points for private bargaining. See Field, \textit{supra} note 11, at 66–69 (discussing default rules for tax elections, in general). As a result, my prior scholarship spends a little time discussing default rules for tax elections, but the discussion herein elaborates significantly on my prior work.

\textsuperscript{143} The allocation of the power to make the tax election could be understood as an “altering rule” — rules that define what is required in order to opt out of a particular default rule that has been selected. See McDonnell, \textit{supra} note 114, at 385.
\end{footnote}
likely to be less informed (and thus at risk of opportunistic behavior by the other party). Thus, joint elections confer many advantages, which can be especially beneficial if the costs created by joint elections can be minimized.

1. The Case for a General Preference for Joint Elections

Joint elections can be beneficial because (a) they help to empower the less-informed taxpayers who may have difficulty protecting themselves through bargaining, (b) they can take advantage of cognitive biases to promote cooperation between taxpayers, and (c) they can decrease the risk of government whipsaw. These potential benefits will be discussed in turn.

a. Empowering the Less-Informed to Bargain

Joint elections can serve an information-forcing function, incentivizing more knowledgeable taxpayers to disclose information about the law, about the facts and about their private valuations. All of that information can help the less-informed taxpayers make more educated decisions about their tax treatment and can put them in a position to negotiate more effectively.\(^\text{144}\)

Specifically, a joint election encourages a party that has better knowledge of the law (and thus of the availability of the election) to inform the other party about the availability of the election. The latter party must still employ its own counsel to get advice about how the law will apply, but the former party’s revelation about the law empowers the latter party to know to ask counsel about the election. For example, if a noncustodial parent would like to claim the dependency exemption for a child, he must involve the custodial parent; absent the query from the noncustodial parent, the custodial parent may not have even known that there was an option to reallocate the dependency exemption and to potentially extract additional support payments from the noncustodial parent.

In addition, a joint election can push the better-informed party to disclose facts about a larger overall factual plan. In a corporate acquisition to which a regular section 338 election could apply, a single corporate purchaser could purchase target corporation stock from a wide variety of sellers over a twelve month period in a series of separate transactions.\(^\text{145}\) As discussed above, the regular section 338 election can be made unilaterally

\(^{144}\) This benefit of joint elections depends on there being informational asymmetries between the parties. Where the parties have roughly equal information, joint elections used for information-forcing purposes are likely to have very little value.

\(^{145}\) See supra Part II.C.
by the buyer corporation. Since the buyer’s ability to make the election does not depend on the sellers’ participation, the buyer has little incentive to disclose to the sellers the facts of the overall acquisition plan unless the sellers specifically ask. In contrast, if a regular section 338 election had to be made jointly by the buyer and the sellers, a buyer that is purchasing the stock of a foreign target corporation\textsuperscript{146} in a series of transactions over time would have an incentive to tell the individual sellers about the overall acquisition plan. That disclosure would be necessary in order for the buyer corporation to secure the sellers’ cooperation in making the election. The buyer corporation would likely disclose the overall acquisition plan during each of the original transaction negotiations, and the buyer would likely try to include a provision in the acquisition contract obligating each individual seller to participate in making the election. Even if the buyer corporation does not reveal the overall acquisition plan until after a particular seller’s sale is complete, a joint election would require the buyer corporation to approach the seller after the acquisition and reenter negotiations in order to obtain the seller’s consent to the election. Either way, a joint election forces the buyer corporation to reveal to each seller the overall acquisition plan, which may alert each seller to the possibility that an election could apply to the transaction. This may enable each such seller to protect himself better through negotiation.\textsuperscript{147}

Furthermore, when one party approaches another and reveals information about the facts and/or the law, the opening offer by the first party helps the other party gain insight into the first party’s tax and financial situation. This reveals some otherwise private information about the value of the election to the first party, which can help the less-informed party better price any agreement.

In addition, by giving the less-informed party some power over the tax choice, joint elections provide an opportunity for that party to better protect itself through the exercise of that power. That is, the revelation of information is useful to the less-informed party, but the information may do that party very little good if that party has limited ability to act on that information.\textsuperscript{148} The requirement that a party participate in making an

\textsuperscript{146} Remember that, generally, a regular section 338 election does not affect the tax treatment of the sellers, except in limited types of acquisitions of foreign target corporations. See supra Part II.C.

\textsuperscript{147} The analysis of the allocation of power for section 336(e) elections is quite similar to that described here for section 338.

\textsuperscript{148} Conceivably, the less-informed party could act on the information (and thereby try to protect itself) by negotiating with the other party. But, absent decision-making power vested by law, the less-informed party’s primary tool for negotiation is money. The less-
election helps to prevent another party from imposing adverse consequences on the first party without its consent. For example, the election to change the allocation of the dependency exemption requires joint action by both former spouses; the participation of the custodial parent in this choice prevents the noncustodial parent from taking the dependency exemption away from the custodial parent without the custodial parent’s consent. In contrast, the fact that the regular section 338 election can be made unilaterally by the buyer corporation means that certain sellers of stock in a foreign corporation could be subjected to adverse tax consequences without their consent if the buyer corporation decides to make the election. Of course, the opportunity to be involved in the decision-making process does not guarantee that taxpayers will be able to effectively protect themselves and negotiate toward efficient bargains, as taxpayers may make uneducated or ill-advised decisions. The legally established entitlement to participate in the choice does, however, give the at-risk taxpayers an additional tool to help protect themselves.

Notwithstanding the foregoing, unilateral elections could serve many of these information-forcing and self-protection functions, if the more-informed party can be clearly identified. That is, if the default rules could be constructed to always disfavor the more-informed party and always favor the less-informed taxpayer, and if the latter taxpayer had the unilateral power to make the relevant election, the more-informed party would be incentivized to reveal information about the law, facts, and valuation in order to entice the first party to make the election. In that situation, the election could not be exercised in a way that harms the less-informed taxpayer without that taxpayer’s consent.

However, clear identification of the less-informed party can be difficult, meaning that, in such cases, a unilateral election is unlikely to be particularly effective for protecting the less-informed party (whoever that informed party could pay the other party in order to induce that other party to make the election choice that is more favorable to the less-informed party. To the extent there is a correlation between possession of information and possession of wealth, the less-informed party may not have sufficient funds to protect itself by compensating the other party. Hence, using the law to vest power in the less-informed party gives that party another tool to use in the negotiation — legally mandated consent.

Note that this approach also requires the clear identification of which tax treatment favors that more vulnerable party. While some generalizations can be made about preferences for default rules, taxpayers’ preferred tax treatments often vary with the taxpayers’ individual tax situations. Thus, even if the less-informed party can be identified with a high degree of certainty, it can sometimes be difficult to determine which default rule disfavors the more-informed party; as a result, an effective information-forcing unilateral election may be difficult to design. See supra Part IV.B.
may be). For example, in the context of the dependency exemption, query whether the custodial or noncustodial parent is likely to be less-informed; the noncustodial parent may be a sophisticated primary breadwinner (in which case the custodial parent is likely less-informed), an ignorant deadbeat (in which case the custodial parent is likely more-informed), or something in between. Thus, in this type of situation, where the identification of the less-informed party is subject to significant uncertainty, a joint election can be particularly valuable. This is because the joint election ensures that the less-informed party (whoever it may be) always has a right to participate in the choice, meaning that the more-informed party will be incentivized to reveal information if it wants the election to be made. Further, even where an information-forcing unilateral election can be used to empower the less-informed party to bargain, this unilateral approach requires that the more-informed taxpayer’s individual preference be systematically determinable, which is often not the case.

Additionally, the use of a unilateral election foregoes some of the other benefits of joint elections discussed below.

b. Leveraging Cognitive Biases to Facilitate Cooperation

Joint elections can also take advantage of cognitive biases by framing the decision as a joint choice rather than as an individual one. This framing may help to set up the choice as one on which the parties should cooperate, and this may be particularly useful for elections, like the election regarding the tax treatment of alimony, where part of the goal in providing the election is to facilitate cooperative tax planning among taxpayers. That election requires the affirmative consent of both former spouses in order to change the tax treatment of alimony, and that consent generally needs to be

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150 For example, where one parent was a stay-at-home parent with primary childcare responsibilities and one parent was the primary breadwinner, primary custody may be assigned to the former because she has a closer personal relationship with the child. Assuming a correlation between high levels of income and high levels of information (or access thereto), the custodial parent is likely to be less informed than the noncustodial parent.

151 For example, primary custody may be assigned to a particular parent because that parent has greater ability to provide for the child and/or because the noncustodial parent is unavailable or unable to care for themselves or the child. Assuming again a correlation between high levels of income and high levels of information (or access thereto), the custodial parent in this situation is likely to be more informed than the noncustodial parent.

152 Of course, as discussed further below, this approach does put increased pressure on the choice of default rule. See infra Part IV.B (discussing the choice of default rules).

153 See infra Part IV.B.
provided in a single agreement that is negotiated, prepared, and signed through joint effort.

The election regarding the allocation of the dependency exemption does not use the framing heuristic quite as successfully. Although the election requires joint action (in that the noncustodial parent must attach to his tax return the custodial parent’s release of the exemption), the election does not frame the choice as a joint decision. Rather, the tax law empowers the custodial parent to have control over the choice; the decision to release the exemption belongs to the custodial parent, and in order to effectuate the release, only the custodial parent’s signature is required on the release form. This frames the decision more like an individual choice belonging to the custodial parent, which may not facilitate cooperation as clearly as the framing in the alimony election. If policymakers want to promote cooperative tax planning among divorced parents of dependent children, the election could be rewritten to clearly require joint decision-making and not merely joint action.

A joint election also serves, at least in part, to split the original endowment between the multiple parties because neither party has the sole power to make the tax choice. This division of power between multiple parties divides the legal entitlement, which has the possibility of facilitating trade among those parties.

While joint elections may have some success in promoting bargaining through framing, the benefit of using a joint election to try to split the

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154 Policymakers may or may not have this as a goal. However, the objective of this section is to point out that an election requiring joint decision-making has power to frame the choice as cooperative, if that is a desired result. Of course, the use of cognitive heuristics when designing laws likely affects behavior only “on the margins.” Nevertheless, a similar framing approach, whereby

altered custody standards that emphasize each parent’s continuing importance to the child[...], appear to be useful in encouraging parents to actively participate in their children’s lives. Changed nomenclature — for example, some states now use the term ‘parenting plan’ instead of ‘custody and visitation’ — may also work to reduce the sense that there are custody ‘winners’ and ‘losers’ and thus to promote parental cooperation.


155 As long as the default rule for the dependency exemption remains as is, distributional problems are unlikely to be created by more explicitly requiring joint action.

original endowment among the parties is likely modest at best. There are at least two reasons for this. First, the entitlement could almost as easily be split by giving unilateral power to one party while choosing a default rule that favors the other party. Second, requiring multiple parties to cooperate in the decision-making process may actually entrench the default rules, thereby exacerbating the status quo bias. Similarly, the anchoring effect is unlikely to be affected by the use of a joint election rather than a unilateral election. In fact, the anchoring effect may be intensified by a joint election because, in order to change subsequent elections, multiple parties (rather than just one party) must escape the influence of the original election decision.

c. Increasing Compliance & Minimizing Whipsaw

Joint elections also force all of the relevant taxpayers to make affirmative commitments to consistent tax treatment, thereby increasing compliance and minimizing whipsaw. As mentioned above, tax-minimizing elections by taxpayers reduce revenue for the government. Although the provision of the election is tantamount to the government’s implicit consent to forego this revenue, the taxpayers should not be able to reduce their taxes by an amount larger than the amount of revenue that the government implicitly agreed to forego. Thus, it is important that the multiple taxpayers affected by an election adopt consistent treatment in order to minimize the risk of government whipsaw.

Inconsistent treatment presents a risk of whipsaw because elections that benefit one taxpayer often adversely affect another taxpayer. For example, if taxpayers agree to make the election with respect to the tax treatment of alimony, the recipient benefits because she no longer has to include the alimony payments in her income, but the payor is adversely affected because he can no longer take a deduction for the alimony payments. Consistent treatment among the taxpayers minimizes the

157 See supra notes 149–152 and accompanying text.
158 See supra Part III.B.2.b.
159 See supra Part III.C.
160 Occasionally, an election may benefit all taxpayers affected by the election. See, e.g., supra text accompanying note 82. In that case, the joint election may affect compliance but does not play a role in preventing whipsaw. See also infra Part V.A (taking into account the impact of whether taxpayers’ systematically determinable individual preferences are aligned or opposite).
161 As discussed above, the parties may still agree to make this election if the payee will benefit so much from the election that she will be willing to compensate the payor for the additional tax burden that he must bear as a result of the election.
overall net revenue loss to the government because the tax revenue that the
government loses from the recipient may be at least partially offset by the
extra tax revenue that the government gains from the payor.

Thus, inconsistent treatment poses a risk that the recipient will exclude
the alimony payments from income, while at the same time, the payor takes
a deduction for the alimony payments. This inconsistent treatment would
reduce tax revenue in an amount greater than the reduction that the
government implicitly agreed to when providing the election, and this
reduction in tax revenue could be significant. The desire to increase the
likelihood of consistent treatment is one of the reasons that the rules
regarding the tax treatment of alimony were clarified to ensure that both
parties clearly and affirmatively agree about the treatment.162

A joint election can push all of the relevant parties to affirmatively
commit to a particular tax treatment. This affirmative act may help to
increase compliance, in part because people are generally more willing to
behave in a way that they affirmatively agree to behave,163 and in part
because taxpayers are less able to claim that they did not know about the
proper tax treatment or did not receive the notice that the electing party was
supposed to send.

This may be particularly useful when considering elections that are
currently unilateral (i.e., the regular section 338 election, the section 336(e)
election, and the section 83(b) election). In each of those contexts, the non-
electing party (U.S. sellers of stock in a foreign target corporation, the
target corporation, and the employer, respectively) is informed about the
election because the electing party (the buyer corporation, the seller
corporation, and the employee, respectively) is required to send the non-
electing party a copy of the election.164 However, switching to joint
elections that require all affected parties to consent to the election may help
increase the likelihood that all of the parties (not just the parties who are
currently empowered to make the relevant elections) report their tax
burdens in accordance with the election that is made.

162 See generally Hjorth, supra note 23 at 153–54.
163 See, e.g., Rona L. Levy, Relationship of an Overt Commitment to Task Compliance
164 See supra notes 55, 65, 76; see also Leandra Lederman, Statutory Speed Bumps: The
how the involvement of third parties can provide a structural mechanism for increasing
taxpayer compliance).
2. Reducing the Costs of Joint Elections

Despite the potential benefits conferred through the use of joint elections, joint elections also create some potential problems, including the possibility of increased transaction costs and the risk of opportunistic behavior by taxpayers. Joint elections, however, may still be quite useful to the extent that these disadvantages can be minimized, including by limiting the scope of the joint choice.

a. Controlling Transaction Costs

Although joint elections may help to reduce information costs, \(^{165}\) requiring more parties to participate in the decision-making process can increase get-together, decision, and execution costs. As these transaction costs increase, the strength of the argument for joint elections decreases.

For example, the proposed regulations currently provide that the section 336(e) election is made unilaterally by the corporation disposing of the target corporation stock. It may be particularly unwieldy to try to get consent to a section 336(e) election from all of the individual purchasers or distributees of the target corporation stock. The increased transaction costs associated with involving a potentially very large number of additional taxpayers in the election process could significantly increase costs, thereby making things worse rather than better.

Nevertheless, these transaction costs could be reduced if, instead of providing that the section 336(e) election would be made jointly by the disposing corporation and all of the acquirers of target corporation stock, the election would be made jointly by the disposing corporation and the post-transaction target corporation. In that situation, the second party to the election would be the target corporation, as it exists immediately after the disposition. \(^{166}\) The target corporation would be represented in that choice by its officers and/or board of directors. When deciding whether to consent to the election, those individuals would have a fiduciary obligation to protect the interests of the new shareholders. \(^{167}\) Moreover, the new

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\(^{165}\) See supra Part IV.A.1.a.

\(^{166}\) It is important that the second party to the election be the target corporation as it exists immediately after the QSD. If the pre-QSD target corporation could be the second party to the election, little would be gained because, at that time, the seller corporation (i.e., the first party to the election) would control the target corporation.

\(^{167}\) The seller corporation would have an incentive to negotiate about the election during the rest of the acquisition negotiations, and the seller corporation might try to include a covenant in the acquisition agreement that obligates the target corporation to consent to the election after the QSD (or that obligates the acquirer(s) to cause, or use their best efforts to
shareholders of the target corporation are generally not directly affected by the election; rather, they are affected indirectly because the election affects the target corporation’s basis in its assets. Thus, a joint section 336(e) election where the target corporation itself is the second party to the election actually confers the power to choose on the taxpayer that is most directly affected by the election, and that corporation can act to protect its new shareholders.

The transaction costs could be further reduced by bifurcating the election — requiring the joint choice only in those situations where the less-informed party could be adversely affected by the choice, and otherwise allowing the choice to be made unilaterally.¹⁶⁸ For example, as discussed above, a section 336(e) election often benefits the acquirers of the target corporation stock because the target corporation often takes a stepped-up basis in its assets. The risk posed to the acquirers of the target corporation stock arises primarily where the election results in a stepped-down basis in target corporation assets. Thus, the requirement of joint decision-making could be limited to those section 336(e) elections that result in a step-down in the target corporation’s basis in its assets.

b. Limiting Opportunistic Behavior

In addition to potentially increasing administrative costs, the use of joint elections rather than unilateral elections also gives veto power to all of the parties whose consent is needed. Taxpayers wishing to take advantage of the situation can exercise this veto power opportunistically. As a result, joint elections may empower taxpayers to extract hold-up payments, alter the distribution of the tax benefit of the election, and increase the importance of the default rule. By giving veto power to each party involved

¹⁶⁸ Just as the power to make an election can be bifurcated (i.e., so that the election is partly joint and partly unilateral), the default rule for an election can also be bifurcated (i.e., so that one default rule applies in certain situations, and another default rule applies in other situations). As will be discussed later, bifurcation of the default rule often results in significantly more transaction costs than bifurcation of the power allocation. See supra Part IV.B.3. For example, with the section 336(e) election, bifurcating the default rule means that the parties will likely need to go through the entire section 336(e) election analysis just to determine how the transaction will be taxed in the absence of an election. In contrast, bifurcation of the power allocation would allow the parties to proceed even without considering the possibility of the election, knowing that the transaction will just be treated as a stock disposition.
in an election, the tax law would empower each party to hold up the election process.

Thus, any party who is unaffected or minimally affected by the election could extort the other party for additional compensation by threatening to withhold consent. As a result of this risk, limiting the scope of the joint choice can be an effective alternative. Specifically, the power allocation can, again, be bifurcated, such that joint power is generally only provided to parties who are materially affected by an election; in situations where a party is likely to be indifferent to whether an election is made, that party generally should not be entitled to participate in the choice. Thus, for example, the regular section 338 election should only be a joint election between the buyer corporation and the sellers of target stock to the extent that the sellers are U.S. shareholders selling stock in a foreign target corporation that is a CFC. In other circumstances, the sellers of target corporation stock are generally not affected by a regular section 338 election169 and should not be empowered to veto an election desired by the other parties.

Even where all parties to an election are affected by the election, the veto power that a joint election gives to each party can have distributional consequences. For example, if the section 83(b) election was joint instead of unilateral, then the employer’s veto power might enable the employer to extract some of the value of the election from the employee, even if the employer might otherwise be able to make itself indifferent to whether the election is made. Similarly, the section 338(h)(10) election affects both the buyer corporation and the seller corporation; the buyer corporation generally benefits from the election as long as the target corporation’s assets have appreciated. However, the fact that the joint election empowers the buyer corporation to veto an election that may be desired by the seller corporation means that the buyer corporation can extract extra compensation from the seller corporation (typically in the form of a reduction in purchase price) in exchange for the buyer corporation’s consent. This effectively redistributes part of the tax benefit of the election.

169 An exception to this is if the sellers have affirmatively agreed to indemnify the buyer for pre-closing taxes of the target company, which would then include the tax liabilities that arise as a result of the old target’s deemed asset sale. See supra note 62 and accompanying text. The adverse tax consequence would affect the sellers more as a result of the negotiation regarding the indemnity rather than as a result of the election itself. Thus, the sellers would not really need the election parameters to help protect themselves; rather, if the adverse consequence arises because of negotiation, the sellers should also protect themselves through that negotiation.
from the seller to the buyer.\textsuperscript{170} Thus, where there is a policy reason to encourage the parties affected by the election to share the value of the benefit of the election (as with the election regarding the tax treatment of alimony), a joint election may be useful to help achieve that distributional goal.\textsuperscript{171} If, however, the potential tax benefit of the election should, from a normative perspective, belong to one party and not to the other, then a joint election could interfere with that distributional objective.

Moreover, empowering both parties affected by election to veto the election increases the importance of the default rule because the joint choice may create an additional impediment to the parties' abilities to opt into the alternative treatment. This could cause default rules, which are already sticky because of cognitive biases, to be even stickier. As a result, default rules should also be selected with care.

\textbf{B. Defining Default Rules}

In the extensive literature about the design of default rules in contract and corporate law,\textsuperscript{172} scholars often seek to determine what default rule will best maximize efficiency or welfare,\textsuperscript{173} typically arguing among a few basic

\textsuperscript{170} Two commentators have argued that this distribution of the tax benefit of the election is misallocated. See Seago & Barkhi, \textit{supra} note 68.

\textsuperscript{171} One other way to accomplish this distributional objective is to make the election a unilateral choice by the party that would be disadvantaged by the election. For example, the election regarding the tax treatment of alimony could be designed as a unilateral election by the payor. This would still likely result in a sharing of the tax benefit of the election because the election would generally harm the payor (in that he would have fewer deductions) and thus he would be disinclined to make the election unless the alimony recipient shared some of the benefit with the payor. However, even though a unilateral election could achieve this distributional goal, a unilateral election foregoes the framing and compliance benefits of joint elections.


\textsuperscript{173} See, e.g., Ayres \& Gertner, \textit{supra} note 172, at 95 (discussing when "it may be efficient to choose a rule that a majority of people actually disfavor"); Sunstein, \textit{supra} note 121, at 111, 128 (suggesting that it may be the case that "[w]hat really matters is welfare, not efficiency; the latter is best understood as a crude proxy for the former" but recognizing that it may be difficult to try to select default rules that best maximize welfare, given that "the
alternatives. One approach to default rules is to employ a penalty default rule — a default rule that is “purposefully set at what the parties would not want” in order to “give at least one party ... an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer,” thereby inducing “valuable information revelation with low transaction costs.” An alternative approach is to use a preference-meeting default rule — a default rule that reflects the terms for which the parties would have negotiated if they had full information and if there were no impediments to bargaining. Additionally, some scholars advocate for some type of approach in the middle of those two methods.

This debate can be helpful in analyzing how to set default rules for tax elections. This is true both in the specific context of elections that are tax bargaining focal points, where multiple private parties negotiate with each other to reach an agreement about whether to contract out of the default rule that would otherwise determine all of their tax consequences, and in general, where tax elections can be conceived of “as the taxpayer’s opportunity to contract out of a default term in an implied agreement between the taxpayer and the government.”

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174 Ayres & Gertner, supra note 172, at 91.

175 Id. at 128. Penalty default rules are a subset of “minoritarian” default rules, which among other things, seek to protect certain parties from exploitation.

176 See, e.g., Easterbrook & Fischel, supra note 172. There are a variety of formulations of this concept, but they generally capture the same approach. See, e.g., Ian Ayres & Robert Gertner, Majoritarian vs. Minoritarian Defaults, 51 STAN. L. REV. 1591, 1591 (1999) (calling “majoritarian” default rules those that set terms based “by simply asking what most parties would have contracted for had they written a complete contract”); Charles J. Goetz & Robert E. Scott, The Mitigation Principle: Toward a General Theory of Contractual Obligation, 69 VA. L. REV. 967, 971 (1983) (explaining this type of default rule as one where “the preformulated rules supplied by the [government] should mimic the agreements contracting parties would reach were they costlessly to bargain out each detail of the transaction”).

177 See, e.g., Alarie, supra note 156, at 161–62 (arguing for an “intermediate default rule” in the context of insider trading). Another approach would be not to provide a default rule at all, and instead require an “active choice” by the parties. This could also be conceived of as a “double penalty default” — disfavoring all taxpayers by, for example denying any parent the ability to take a dependency exemption, unless the parents cooperate and make an affirmative choice as to the allocation of the exemption. See Sunstein & Thaler, supra note 124, at 1189 (discussing the possibility of requiring an “active choice”). However, this approach is likely to create significant transaction costs, compliance issues, and a perception of unfairness.

178 Field, supra note 11, at 67.
Thus, the discussion in this subpart first endeavors to determine whether, and in what circumstances, a penalty default, a preference-meeting default, or an intermediate default will best enable multiple taxpayers to bargain and exercise an election in a way that minimizes their aggregate tax burden. Again, policymakers’ abilities to design a default rule that effectively facilitates bargaining and reduces transaction costs depend very heavily on the determinability of taxpayers’ individual preferences and of the directionality of any informational asymmetry.

As the following will illustrate, sometimes it is difficult to design an effective default rule, and sometimes the following analysis suggests multiple possible conflicting default rules. Particularly for these situations, this subpart also highlights some other, possibly competing, policy considerations relevant to the choice of default rule, including complexity, administrability, distributive concerns, and other social policy issues. Furthermore, it may be difficult to select default rules that best balance the possibly competing considerations, but this part explains the analysis and tries to provide some guidance.

1. The Case for Penalty Default Rules

Penalty default rules are default rules that are unfavorable to at least one party; this type of default rule gives the disfavored party “an incentive to contract around the default rules and therefore to choose affirmatively the contract provision [it] prefer[s].” Effective penalty default rules require the identification of the party that is most likely to have the relevant information and the identification of the tax result that would be unfavorable to that party. If both can be identified, then the tax result that

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179 This analysis treats taxpayers’ abilities to exercise an explicit election in a way that reduces their aggregate tax burden as a crude proxy for welfare maximization, (a) at least as between the multiple parties that are directly affected by the election, and (b) possibly in general, to the extent that the government’s provision of the explicit election opportunity for good reason can be understood as a concession by the government that aggregate societal welfare is maximized if, in these specific limited circumstances, the taxpayers are able to cooperate to minimize their aggregate taxes. See also supra notes 81–84.

180 Ayres & Gertner, supra note 172, at 91.

181 In the context of tax elections that affect the tax treatment of multiple taxpayers, a penalty default rule also requires that the taxpayers can obtain an aggregate benefit from negotiation. That is, the concept of a penalty default assumes that, as between the taxpayers as a group and the government, the default rule generally favors the government and, in the aggregate, disfavors the taxpayers. It is only in this situation where an election out of the default rule would reduce tax revenue for the government and generate extra value for the taxpayers as a group, such that there are gains available for the taxpayers if they bargain and cooperate.
is unfavorable to the informed party can be selected as the default rule. As long as the less-informed party has some power over whether the election is made, then the more-informed party, who needs the participation of the less-informed party in order to make the election, has an economic incentive to inform the less-informed party about the opportunity for joint tax minimization. Thus, penalty default rules can help overcome the problem of asymmetric information, which can be a significant barrier to effective bargaining. Where the value of the information revealed exceeds the transaction costs involved in bargaining, the penalty default rule can lead to an efficient result.

Penalty default rules can be used to induce one taxpayer to reveal valuable information to another taxpayer, or to induce the taxpayers as a group to reveal valuable information to the government. For an example

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182 A slight variation on the penalty default rule is as follows. Assume that the more-informed party can be identified, but that it is difficult to determine the tax result that would be unfavorable to that party. If the tax result that is favorable to the less-informed party can be determined with reasonable certainty, then that tax result can be selected as the default rule. Given the uncertainty of the more-informed party’s individual tax preferences, the selected default may or may not be desired by the more-informed party, depending on the particular facts and circumstances. Nevertheless, this default rule largely accomplishes the same information-forcing goals as the traditionally defined penalty default rule. In the situations where the selected default rule is unfavorable to the more-informed party, the default will operate like a traditional penalty default rule, incentivizing the more-informed party to reveal information and contract around the default provision. In those situations where the selected default rule is favorable to the more-informed party (i.e., where the party’s individual preferences are aligned), the default rule will operate like a preference meeting default rule.

183 That is, the less-informed party either has unilateral power to make the election or has joint power (with the more-informed party) to make the election. This is an important way in which the two key election parameters discussed in this article are intertwined. See supra Part IV.A. Penalty default rules can generally achieve the benefits discussed in this section only if the more-informed taxpayer (i.e., the one being “penalized” by the penalty default) does not have unilateral power to opt out of the default rule without participation of other taxpayer. The allocation of power to make elections is addressed above in Part IV.A. For now, the remainder of this discussion about penalty default rules assume that the less-informed taxpayer either has unilateral power or joint power (with the more-informed party) to make the election.

184 See supra Part III.B.1.a.

185 Hirsch, supra note 122, at 1058.

186 Where two parties (taxpayer and the government) are affected by an election, there are a limited number of permutations for default rules — either a default favors the taxpayers and disfavors the government or vice versa. Where three parties (taxpayer 1, taxpayer 2, and the government) are affected by an election, there are many more permutations: the default could favor both taxpayers and disfavor the government, or vice versa; the default could
of the former,\textsuperscript{187} consider the tax treatment of alimony payments. The taxpayers generally have clear, opposing individual preferences — the payor would prefer to be able to deduct the payment of alimony from income, and the recipient would prefer to be able to exclude from income the receipt of the alimony payments.\textsuperscript{188} Assuming that the party with more income has more information about the law (or access thereto), the taxpayer paying the alimony\textsuperscript{189} is more likely to be the better-informed party. Thus, a penalty default rule for the tax treatment of alimony would provide that the payor of alimony cannot deduct the amount paid, and the recipient of the alimony can exclude the amount received from income.\textsuperscript{190} While this rule provides an individual benefit to the recipient of the alimony, this default rule disfavors the party that is likely more informed — the payor of the alimony — and also likely disfavors the taxpayers as a group.\textsuperscript{191} Consequently (and assuming that the recipient of the alimony has some power over the choice), the payor of the alimony would have an economic incentive to inform the recipient of the alimony of the opportunity to minimize their aggregate taxes by opting for the alternate tax treatment.

\begin{footnotesize}
\textsuperscript{187} For an example of the latter — penalty defaults that incentivize the revelation of valuable information from the taxpayers, as a group, to the government — consider two of the corporate acquisition elections. As long as assets have appreciated in value, both buyers and sellers generally favor dispositions of the stock of controlled corporate subsidiaries to be treated as dispositions of the assets of those corporate subsidiaries (i.e., to have section 338(h)(10) and section 336(e) elections). Thus, a default rule that does not provide for “deemed asset dispositions” treatment of these “actual stock dispositions” incentivizes the taxpayers to provide sufficient information to the government to establish that the transaction is eligible for the particular election (i.e., that the party disposing of the stock is, in fact, disposing of stock constituting 80% vote and 80% value of the subsidiary). This information may be valuable because it can help increase compliance and enable enforcement of the tax rules regarding the treatment of these dispositions. In this way, the default rules of section 338(h)(10) and section 336(e) could be conceived of as a penalty default rule aimed at the taxpayers, as a unit.

\textsuperscript{188} See supra Part II.A.1. This assumes that taxpayers generally prefer to reduce their tax liabilities.

\textsuperscript{189} Generally, alimony payments flow from the ex-spouse with more income to the ex-spouse with less income.

\textsuperscript{190} This was the Code’s original default treatment of alimony. See supra note 27. Remember that this is not the current default treatment of alimony.

\textsuperscript{191} If the payor of the alimony is in a higher tax bracket than the recipient of the alimony, then the ability of the payor to deduct the payment is worth more than the ability of the recipient to exclude the payment.
\end{footnotesize}
Because the alimony-recipient is made aware of this tax minimization opportunity, she is in a position to bargain more effectively with her ex-spouse about their financial arrangement and protect herself from possible opportunistic behavior. As part of the bargain, the alimony-payor would likely be willing to compensate the alimony-recipient enough to make the alimony-recipient willing to give up the tax benefit of the default rule (i.e., at least as much as the alimony-recipient will have to pay in taxes were she to include the alimony in income).192

Of course, a default rule that favors a less-informed party does not guarantee that the taxpayer will be able to bargain effectively or that the taxpayers, as a unit, will reach the agreement that best minimizes their aggregate tax burden. Taxpayers may make uneducated or ill-advised decisions. Also, particularly in situations like divorce that involve a great deal of emotion, there is a real risk that parties will fail to bargain even if bargaining would result in their payment of less aggregate tax.193

Moreover, default rules can be quite sticky, and thus, penalty default rules can actually impede the taxpayers from reaching tax-minimizing bargains. In particular, the status quo bias entrenches default rules because of the preference that people have for the current state of the world over alternatives.194 Further, a penalty default rule that disfavors the more-informed party and favors the less-informed party frames the question in a way that effectively asks the less-informed party whether (and in exchange for how much compensation) he or she is willing to “give up” a particular tax treatment. When the question is framed in this way, taxpayers may feel endowed with the initial entitlement conferred by the default rule and may be averse to losing that particular tax treatment, although this bias may not operate particularly strongly.

Even if the taxpayers can overcome these cognitive biases, penalty default rules can be sticky because of increased transaction costs. Specifically, as compared to a default rule that best minimizes the affected taxpayers’ aggregate tax cost, where very few sets of taxpayers will be incentivized to negotiate, a penalty default rule, by definition, will cause more sets of taxpayers to want to bargain around the default rule, thereby increasing get-together costs.195 Similarly, execution costs will increase

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192 This approach would likely have helped Irene protect herself in the example described in note 9, supra.

193 See Sunstein, supra note 121, at 110 (noting that switching a default rule to favor an irrational party might decrease overall welfare because of the irrational party’s unwillingness to trade).

194 See supra Part III.B.2.b.

195 See supra Part III.B.1.b.
because so many more sets of taxpayers will likely want to elect out of the penalty default. Ultimately, "the stickier the penalty default, the more ineffectual" it is likely to be.\footnote{See Hirsch, supra note 122, at 1060.} All of this suggests that penalty default rules should be used with caution — only where the increased costs created by penalty defaults, which can be sticky, are outweighed by the value of the informational disclosure.

In addition, the potential information-forcing benefits of penalty default rules depend on the ability of policymakers to design these rules with reasonable certainty. This may be a challenging task for several reasons, including because of the difficulty in predicting which taxpayer is likely to have more information.\footnote{Note that there may be distributional reasons to choose a default rule that favors a weaker party, even if the choice of default rule may not reliably confer information-forcing or negotiating-power benefits. See infra Part IV.B.4.} As discussed above, it can be difficult to generalize about whether a custodial parent or noncustodial parent is likely to be better informed.\footnote{See supra notes 150–51 and accompanying text.}

Additionally, even if the taxpayer with more information can be identified, it may be difficult to predict what default rule will disfavor such party and incentivize that party to initiate information-revealing bargaining.\footnote{See Hirsch, supra note 122; see also supra note 149.} Although it is generally fair to assume that taxpayers wish to reduce their tax burdens,\footnote{There may be some situations where taxpayers will not act in this way. Due to sheer irrationality or strategic behavior, one party may be willing to forego tax minimization in order to prevent the other party from getting any benefit.} sometimes the identification of the tax-reducing alternative depends on the facts and circumstances of the situation — that is, the individual preferences are not systematically determinable. For example, consider a corporate parent disposing of the stock of a corporate subsidiary in a transaction to which section 336(e) could apply; in this situation, it is reasonably clear that the corporate parent disposing of the subsidiary stock is likely to have more information than the acquirers of that stock.\footnote{Specifically, the party disposing of the stock of the subsidiary is more likely to have more information, than any individual acquirer of stock, about whether there is an integrated plan for disposing of "control" of the corporate subsidiary. This is particularly true if there are many acquirers who acquire their stock in a series of separate transactions that occur over time. See supra Part II.C.} However, whether stock disposition-treatment or asset-disposition treatment will better reduce the corporate parent’s tax liability depends, in large part, on how the parent’s basis in the subsidiary’s stock...
compares to the subsidiary’s basis in its assets.\textsuperscript{202} If the former is much higher than the latter, then the corporate parent is unlikely to want asset-disposition treatment. Conversely, if the latter is much higher than the former, then the corporate parent is likely to want asset-disposition treatment.\textsuperscript{203} So, a generally-applicable penalty default is difficult to design.

Ultimately, the more difficult it is to identify with reasonable certainty which party is likely to be more informed, and the more difficult it is to predict with reasonable certainty what the more informed party’s preferences are likely to be, the more difficult it is to establish a penalty default regime, and the less effective any such attempt is likely to be. Plus, given the significant limitations on potential benefits of penalty default rules, penalty default rules should be used sparingly.

2. The Case for Preference-Meeting Default Rules

Another approach to the selection of default rules is to choose a default rule that reflects the terms that the parties would agree to if they had full information and no transaction costs.\textsuperscript{204} In the context of tax bargaining focal points, a preference-meeting default rule would be the option that best minimizes the aggregate tax burden of the directly affected taxpayers.

This approach has several benefits. Preference-meeting defaults can reduce transaction costs “because fewer elections need to be filed, which makes the exercise of the tax choice simpler for the taxpayers and easier to administer for the Service.”\textsuperscript{205} Further, a preference-meeting default rule generally avoids most of the need for bargaining among taxpayers and limits most of the adverse impact that cognitive biases and sheer irrationality could have on the taxpayers’ abilities to reach tax-minimizing decisions. That is, with a default rule that reflects what the taxpayers would select if they had full information and costless bargaining, there is a high likelihood that the taxpayers will end up with the tax-minimizing result, especially where the default rules are sticky.

As with the design of penalty default rules, designing effective preference-meeting default rules requires that the individual preferences of the taxpayers are reasonably determinable. Where the taxpayers’

\textsuperscript{202} See supra note 75 and accompanying text.

\textsuperscript{203} This oversimplifies the analysis somewhat. It is not enough to compare inside and outside basis. This is because the amount realized for the actual stock-disposition transaction differs from the grossed-up amount realized deemed paid in the fictional asset-disposition transaction for reasons including the presence of corporate liabilities. See supra note 75.

\textsuperscript{204} See supra note 176.

\textsuperscript{205} Field, supra note 11, at 67–68.
preferences are quite difficult to predict, as with the section 83(b) election in the employment context, \textsuperscript{206} it would be difficult to select a default rule that reflects what bargaining taxpayers would prefer. Further, preference-meeting default rules are most effective if the individual preferences of the multiple taxpayers affected by the election are generally aligned. Where taxpayers' determinable preferences are not aligned, then both taxpayers' individual preferences cannot be met simultaneously; rather, the preference-meeting default rule can, at best, reflect the alternative that reduces the net tax burden of the group, but not as individuals.

Consider again the example of alimony. The individual preferences of the payor and recipient are in direct opposition — the payor would like the tax benefit of the alimony payment (i.e., a deduction), and so would the recipient (i.e., an exclusion). Thus, their individual preferences cannot both be met at the same time. Nevertheless, assuming again that the payor of the alimony is in a higher tax bracket than the recipient of the alimony, the parties' net preference would be met by allowing the payor to deduct the alimony payment and by requiring the recipient to include the alimony payment in income. Thus, a preference-meeting default rule would provide that alimony is deductible to the payor and includable by the recipient — exactly the default treatment of alimony under the current tax law.\textsuperscript{207} The alimony recipient's systematic individual preference (to exclude the payments from income) is not met, but the aggregate preference of the taxpayers, as a group, is generally met. With the preference-meeting approach to default rules, it matters very little if the parties are affected by cognitive biases or if the parties' behaviors are driven strongly by emotion rather than wealth maximization. These impediments to bargaining just increase the likelihood that the tax treatment of the parties will be governed by the default rule. And, with a preference-meeting default rule, that sticky default rule will generally reflect the tax treatment that minimizes their aggregate tax burden.

Note that preference-meeting approach to the default rule for alimony is the opposite of the penalty default rule for alimony. Both can lead to tax-minimizing results, leaving us with our original question about how to choose the default rule. We will return to this shortly.

For now, it is enough to note that preference-meeting default rules, where they can be designed effectively, can reduce transaction costs and avoid many of the adverse consequences of cognitive biases. These benefits may be significant, particularly in situations where penalty default rules are

\textsuperscript{206} See supra Part II.B.

\textsuperscript{207} I.R.C. §§ 71(a), 215.
unlikely to produce benefits in excess of costs. In particular, where there are unlikely to be significant informational asymmetries (e.g., where the parties are likely to be equally well informed), any information revealed because of a penalty default is likely to be of little value, and thus a preference-meeting default rule may be much more desirable.


It is also possible to consider explicitly bifurcating the default rule, such that a penalty default rule would apply only in the situation(s) where information forcing is likely to be particularly valuable with a high degree of predictability, and such that a preference-meeting default rule would apply in other circumstances.

This approach may be most useful where the identity of the more-informed party and/or the individual preferences of the parties vary depending on facts and circumstances that are easily predictable and definable (i.e., the individual preferences are situationally determinable).210 Said differently, a bifurcated approach may be particularly useful if a penalty default rule would lead to the revelation of valuable information in

208 For example, in a transaction in which a section 338(h)(10) election is to be available, both the seller and the buyer are likely to have relatively equal information with respect to the facts and the law. This is because the transaction generally involves a single corporation selling at least 80% control of the target corporation to a single corporation buying at least 80% control of the target corporation. With supermajority corporate owners on both the sell-side and the buy-side of the transaction, both the buyer and the seller are likely to have reasonably complete information about what transaction is occurring. Further, since the primary buyer and primary seller are corporations, they are at least reasonably likely to have counsel to advise them of the law.

209 Some scholars have advocated for the use of intermediate default rules, that fall somewhere in between penalty default rules and preference-meeting default rules, in an effort to split the entitlement, “unseat otherwise sticky default rules,” and “cause each party to be more willing and cognitively ready to strike an efficient bargain.” Alarie, supra note 156, at 140–41.

210 For example, the intermediate bifurcated approach may not be particularly useful in the tax treatment of alimony for two reasons. First, the individual preferences of the taxpayers generally do not vary at all (i.e., the alimony payor wants to deduct the payment and have the recipient include the payment in income, while the recipient wants to exclude the payment from income and prevent the payor from deducting the payment). Second, the identity of the likely more-informed party (i.e., the alimony payor) generally does not vary, and to the extent that it does vary, it does not vary over a set of facts and circumstances that are clearly definable ex ante. That is, it is possible for the alimony recipient to be more informed, but it is unlikely, and it is difficult to describe with any certainty and predictability the circumstances that would lead to the conclusion that the alimony recipient is the more informed party.
clearly definable limited circumstances, but not in other circumstances. For
example, consider again the corporate parent disposing of the stock of a
corporate subsidiary in a transaction to which section 336(e) could apply.
Neither a generally applicable penalty default rule nor a generally
applicable preference-meeting default rule is easy to design; in part, this is
because the parties' individual preferences (for stock disposition treatment
or asset disposition treatment) vary depending on the circumstances.
Moreover, neither approach is likely to be particularly effective across all
circumstances — a penalty default rule would likely be beneficial in the
limited situation where the less-informed party is at risk of being adversely
affected,211 but in other situations, a penalty default rule would likely create
significant additional transaction costs with very little information-forcing
benefit. Similarly, a preference-meeting default rule would likely be
beneficial in the limited situations where the parties' individual preferences
are generally aligned, but where their individual preferences are generally
not aligned, a "preference-meeting" default rule would do very little to
protect the less-informed party that is at risk of harm. Thus, a bifurcated
default rule could be partly a penalty default (i.e., providing that, where
deemed asset disposition treatment would result in the target corporation
taking a step-down basis in its assets,212 the default rule will tax the

211 Specifically, an information-forcing penalty default rule may be particularly useful
where asset disposition treatment would simultaneously be (1) advantageous to the corporate
parent disposing of the subsidiary stock, in that the corporate parent (i.e., the party with the
information as to whether there has been a QSD to which a section 336(e) election could
apply) would be able to recognize less gain or a larger loss, and (2) disadvantageous to the
acquirers (i.e., the parties more likely to be lacking information about whether there has been
a QSD), in that there would be a step-down in the target corporation's basis in its assets. A
default rule could be designed to impose a penalty solely that context.

212 This penalty default rule could be triggered upon either a step-down in the target
corporation's basis in its aggregate assets or a step-down in the target corporation's basis in
any of its assets. Under the latter approach, the penalty default rule could be triggered in the
vast majority of transactions, even if the inside basis adjustment results in a net benefit to the
target corporation and its new shareholder(s). This could be quite over-inclusive, which
could create significant additional transaction costs without providing much benefit to the
less-informed party. Thus, the former approach is preferable. Admittedly, if the penalty
default rule is triggered only upon a step-down in the target corporation's aggregate basis,
the basis in certain assets could increase while the basis in other assets could decrease. These
shifts might be beneficial or detrimental to the target corporation and its new shareholder(s),
depending on the depreciation schedules of these assets and on the timing of any future
dispositions of these assets. To the extent that these shifts might be detrimental, a penalty
default rule that is triggered only upon a step-down in the aggregate basis of the target
corporation's assets could be somewhat under-inclusive (i.e., this rule would not protect the
new shareholder(s) in all of the situations in which they could face risk of harm).
transaction as a stock disposition), and partly a preference-meeting default (i.e., providing that in other situations where there is a QSD, the transaction will be taxed as a deemed asset disposition, absent taxpayer choice to the contrary).

However, even if this might be effective for encouraging the flow of information in the desired context, it could be quite complicated, thereby increasing transaction costs. In particular, the whole section 336(e) analysis would have to be undertaken just in order to determine the applicable default rule, and that could be quite expensive. In contrast, it may create fewer transaction costs to use the allocation of the power parameter to encourage the flow of this information.\footnote{See supra Part IV.A.1.a, Part IV.A.2.a; supra note 168; see also infra Part V.C.}

4. Conclusion about Default Rules

The foregoing analysis provides guidance about how to select default rules to facilitate tax-minimizing bargaining and to reduce bargaining costs. It suggests that policymakers should use penalty default rules only when they incentivize the revelation of valuable information without creating significant additional costs. Otherwise the analysis suggests that default rules should be selected so as to best reduce the aggregate tax burden of the directly affected parties.

The foregoing analysis, however, provides less clarity than the analysis of how to allocate the power to make choices about tax bargaining focal points. Here, we are left with a number of open questions about the design of default rules. How do we resolve the conflict if, like with the tax treatment of alimony, there are good arguments for a penalty default rule and for a preference-meeting default rule, and if those potential default rules are contradictory? What if, like with the dependency exemption and the section 83(b) election, the above analysis is indeterminate because the difficulty in identifying the party with more information and the difficulty in determining the parties’ individual preferences impede policymakers’ abilities to design effective penalty default rules and or preference-meeting default rules? And even if the above analysis is clear, might there be any reasons not to use the default rule suggested by the above analysis?

These are not easy questions, but analyzing additional policy considerations (separate and apart from facilitation of bargaining and reduction of bargaining costs) may be helpful. Such considerations may include simplicity, administrability, distributive concerns, and other social policy objectives. The challenges, of course, are how to prioritize these
different considerations and how to weigh the policy benefits and
detriments of different possible default rules.

Further, the default rule for an election cannot be selected in isolation.
The choice of default rule must be coordinated with the way in which
power to make the election is allocated among the parties. As discussed
earlier, these two parameters are intertwined, and any recommendation
about the design of a tax bargaining focal point must harmonize both
parameters. Thus, in order for a penalty default rule to be effective, the less-
informed party (i.e., the party to whom the penalty default rule seeks to
disclose information) must have some power over the choice. Where it is
unclear how to design an information forcing penalty default rule because it
is unclear which party is likely to have the relevant information, a joint
election can be used instead to encourage the flow of information without
having to determine the identity of the more-informed party with reasonable
certainty. That is, it is important to determine whether tax bargaining can be
facilitated better by using one parameter rather than another or if it requires
a particular combination of the two parameters.

Admittedly, all of this balancing and coordination can be difficult, can
produce some uncertain results, and can lead to different results depending
on which objectives a policymaker views as most pressing and which
adverse consequences the policymaker considers to be most problematic.
Thus, the next part seeks to provide some general guidance about how to
coordinate the design of the different parameters and balance the potentially
competing considerations.

V. COORDINATING THE JOINT ELECTION PREFERENCE & THE DEFAULT
RULE RECOMMENDATIONS

This part combines and coordinates the recommendations made in Part
IV.A (regarding the power to make the election) and Part IV.B (regarding
the choice of default rule), in an effort to provide generalizable
recommendations about the design of tax bargain facilitating elections in a
variety of cases. As part of this discussion, this part applies this article’s
analysis to the examples discussed in Part II, making a few specific
recommendations for reform.

Given the foregoing analysis, tax bargain facilitating elections can be
divided up based on (a) whether, and in what circumstances, the individual
preferences (i.e., in the absence of any compensating payment or
opportunity for bargaining) of one or both of the parties can be clearly
determined, and (b) whether, and in what circumstances, the identity of the
less-informed party (if any) is reasonably determinable.
With respect to the first question, taxpayers’ individual preferences may be systematically determinable (i.e. where an affected taxpayer will virtually always prefer one particular tax treatment to another), largely indeterminable (i.e., where the individual preferences vary based on the relevant facts and circumstances, and where it is quite difficult to make any generalizations, ex ante, about parties’ individual preferences), or situationally determinable (i.e., where individual preferences vary based on the relevant facts and circumstances, but where there are clear circumstances that are easily definable ex ante, in which the taxpayer will strongly prefer one tax treatment over another). This part considers each situation, taking into account the identifiability of any less-informed party.

A. Systematically Determinable Individual Preferences — Divorce Examples

1. Taxpayers’ Individual Preferences Are Aligned

Where all affected parties have systematically determinable individual preferences and where those individual preferences are aligned, it matters very little whether the election is joint or unilateral, unless there are likely to be information asymmetries between the taxpayers (in which case, the more-informed party should not be entitled to make the election unilaterally) or unless the joint framing produces a significant benefit (in which case, the election should be joint). As to the default rule when the parties’ individual preferences are systematically determinable and aligned, a preference-meeting default rule can minimize transaction costs because such a default rule would reduce the individual tax burdens of both taxpayers.\(^{214}\) In contrast, a penalty default rule that incentivizes the parties to reveal information to the government (i.e., where the default disfavors both taxpayers and favors the fisc) may be useful if the parties, in the aggregate, possess information that would be particularly valuable if revealed to the government.

2. Taxpayers’ Individual Preferences Are NOT Aligned

Of course, parties’ systematically determinable individual preferences are often not aligned. For example, as discussed above, the parties’ systematically determinable individual preferences are in conflict in both the alimony context and in the context of the dependency exemption. Moreover, as discussed above, both contexts likely involve informational

\(^{214}\) This actually may be a situation where the election should just be eliminated.
asymmetries between the taxpayers. In some circumstances, as with alimony, the directionality of the informational asymmetry is reasonably clear. In other circumstances, as with the dependency exemption, the directionality of the informational asymmetry is quite unclear.\(^{215}\)

### a. Clear Directionality of Informational Asymmetry — the Example of Alimony

As discussed above in the context of alimony, where parties' systematically determinable individual preference are in conflict and where the directionality of the informational asymmetry between the taxpayers is reasonably clear, both a penalty default rule and a preference-meeting default rule are relatively easy to design, and both are likely to lead to the tax treatment that best reduces the taxpayers' aggregate tax burden. However, a penalty default rule for alimony (no deduction for payor and no inclusion for recipient) and a preference-meeting default rule for alimony (deduction for payor and inclusion for recipient) are in direct conflict.\(^{216}\)

Thus, the choice of default rule becomes more difficult.

In resolving this conflict, it is useful to note that the choice of default rule alters the power dynamic among the taxpayers and can confer a distributional benefit on one of the taxpayers. Thus, if policymakers can identify a distributional reason to favor one taxpayer affected by an election over another taxpayer affected by an election, they can try to select a default rule that best serves the economic interests of that favored party. A default rule that favors one party generally means either that party will get the favorable treatment conferred by the default rule,\(^{217}\) or that party will be in

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\(^{215}\) It is also possible to have an election where the parties have systematically determinable, but opposite, individual preferences, and where it is relatively clear that there is little or no informational asymmetry. In such a case, a default rule that meets the net preferences of the parties can minimize transaction costs because the taxpayers would be unlikely to want to opt out of the default. But, if there is a distributional or other social policy reason to favor one party over another, the default can be chosen to favor that party. Also, if the parties, in the aggregate, possess information that would be particularly valuable if revealed to the government, a penalty default rule (i.e., where the default rule provides for the opposite of the parties' net preference) could incentivize the parties to reveal information to the government in order to opt for the tax minimizing alternative.

\(^{216}\) See supra notes 187–92 and accompanying text (discussing a penalty default rule); supra text accompanying note 207 (discussing a preference-meeting default rule).

\(^{217}\) It is possible that the party that is intended to be favored by the choice of default rule may not be better off with that default rule than the party was with the opposite default rule. This is, in part, because the benefits that policymakers try to confer on the favored party can be priced into the underlying private bargain. See Sunstein, supra note 121, at 111 (suggesting that the effect of flipping a default rule might be "modest" if the existing default
a position of power in negotiations, meaning that the party will be able to demand compensation in order to accept less favorable treatment.\textsuperscript{218} So, in the context of alimony, if policymakers believe that prospective alimony payors, by virtue of their high income and sophistication, have an unfair bargaining advantage over prospective alimony recipients,\textsuperscript{219} policymakers may lean toward using the penalty default, rather than the preference-meeting default, for the tax treatment of alimony. The penalty default, which would treat alimony as excludable for the recipient and non-deductible by the payor, confers the favorable tax treatment on the recipient, thereby helping to level the bargaining playing field between the stronger, more-informed party and the more vulnerable, less-informed party. Further, given that cognitive biases can make default rules "sticky," a default rule that favors the alimony recipient is quite likely to help the recipient protect herself from opportunistic behavior of the alimony payor. Together, these considerations may argue that, on balance, a penalty default rule should be used for the tax treatment of alimony — the reverse of the current default rule.

In addition, policymakers must consider how effectively a chosen default rule will accomplish the particular policy objective. For example, in the context of alimony, there is a risk that the penalty default rule may be so sticky that the parties may not be able to overcome the animosity and emotion that serve as barriers to bargaining. In that case, the parties will be unable to cooperate to minimize their tax burden, and the penalty default rule would be unlikely to yield the desired information-forcing benefits. Further, even if the parties can contract around a sticky penalty default rule, an alimony recipient may not receive the distributional advantage that policymakers hope to grant by using a penalty default rule. This is because, among other reasons, the alimony payor may fight to reduce the amount of the alimony in light of the flipped tax default rule. That is, he may price the impact of the tax rules into the amount of alimony he is willing to pay, thereby shifting some or all of the incidence of the intended distributional benefit over to him and away from her. Thus, these concerns may weaken slightly the argument for flipping the current default rule for alimony.\textsuperscript{220}

\textsuperscript{218} Again, this discussion continues to assume that the party favored by the default rule will have some power to decide whether there will be an election out of the default rule.

\textsuperscript{219} This assumes that policymakers believe such a distributional shift would be desirable, although many policymakers may not agree.

\textsuperscript{220} Another concern is that such a change is likely to create significant transition issues, particularly with respect to alimony agreements already in place. For example, switching the default rule may result in windfalls for the payees, particularly where the existing default
Assuming a penalty default rule for the tax treatment of alimony is, on balance, desirable, the less-informed party (i.e., the alimony recipient) must retain some power over the election in order for the penalty default rule to be effective. This can be accomplished either by giving the less-informed party the unilateral power to make the election or by providing that the election must be made jointly by both parties. While a unilateral election may reduce execution costs slightly, a joint election creates greater benefits. Specifically, as noted above, a joint election takes advantage of the framing heuristic, in that a joint choice presents the decision as collaborative, which may help encourage the parties to work together even in the face of great emotion or animus. Moreover, compliance can be increased, disputes reduced, and whipsaw minimized if the taxpayers involved, who generally have opposing individual preferences, both affirmatively agree to a particular joint tax treatment. This suggests that the allocation of power for the alimony election should remain as is — joint.

b. **Unclear Directionality of Informational Asymmetry — the Example of the Dependency Exemption**

The analysis will differ if the directionality of the informational asymmetry is unclear. Even where the parties have systematically determinable individual preferences, it may be difficult to design either a penalty default rule or a preference-meeting default rule without knowing which party is likely to be less-informed. Where the default rule analysis is indeterminate, policymakers may have to select a default rule based on distributional considerations and other tax norms. However, regardless of the default rule ultimately chosen, any election out of the default rule should be made jointly, as involving both parties in the election process increases the likelihood that the more-informed party (whoever that may be) will reveal relevant information to the less-informed party in order to obtain the latter's participation in the election.

For an example, consider the allocation of the dependency exemption among divorced parents of a dependent child. As discussed earlier, although the parties have systematically determinable individual preferences (each prefers to have the dependency exemption), it may be hard to generalize about which parent is less-informed. Recall that this is because it is difficult to generalize about whether the custodial parent has custody (a) because she is the primary caregiver while her ex-husband is the primary breadwinner or rule is already effectively priced into the original agreement. Nevertheless, these issues could be mitigated with a transition rule that provides that the new default rule only applies to alimony agreements established or significantly modified after the enactment of the change.
(b) because the noncustodial parent is simply unavailable.221

As a result, the penalty default/preference-meeting default analysis is indeterminate. Assume, for a moment, that the noncustodial parent is the primary breadwinner,222 the default rule analysis here would mirror the default rule analysis for the treatment of alimony payments. That is, the noncustodial parent would be likely to have greater income and greater information, and by selecting a default rule that is unfavorable to that parent (i.e., allocation of the dependency exemption to the custodial parent), the rule can encourage the noncustodial parent to share information with the custodial parent about the opportunity to reduce their aggregate tax burden through cooperation. Further, this approach might confer a distributional and power-dynamic benefit on the custodial parent, possibly giving her additional leverage to share in the value of the exemption.

There are two key problems with the foregoing. First, the assumption about the noncustodial parent might be wrong in a particular case. The noncustodial parent may be a “deadbeat,” so he might have little information to share, little to gain through negotiating about the allocation of the exemption, and a low likelihood that he would even be able to overcome the get-together costs of negotiating. Second, even if the assumption about the noncustodial parent breadwinner is accurate, the dependency exemption phases out at high income levels, so it will not necessarily be the case that the noncustodial parent, even if he had information about the law, would have any monetary benefit to gain from negotiation. Thus, the penalty default approach would not work in these situations. Similarly, a preference-meeting default rule approach would be equally unsuccessful because it is unclear ex ante what the net preferences of the parties would be. That is, even if policymakers wanted to allocate the dependency exemption to the party for whom it would be most valuable (i.e., the allocation to which the parties would agree if there were no impediments to bargaining), it is not clear whether this is likely to be the custodial or noncustodial parent.

Given that the penalty default/preference-meeting default rule analysis is indeterminate for the dependency exemption, policymakers should be guided by distributional considerations and other tax norms. So, for example, a default rule that favors the custodial parent advances a social policy goal of the dependency exemption — to adjust tax burdens to help

221 Recall that it was also unclear how the dependency exemption should generally be allocated to reduce the aggregate tax burden of the parents. See supra Part II.A.2.
222 This analysis could just have easily started with the opposite assumption and then walked through the default rule analysis on that assumption, ultimately leading to the same recommendations.
parents who are supporting children.\textsuperscript{223} Allocation of the dependency exemption to the parent with custody of the children directs the tax benefit to the household in which the children primarily reside, thereby hopefully conferring a distributional benefit on these households. Moreover, by choosing a default rule that favors the custodial parent, the tax law empowers the custodial parent\textsuperscript{224} to have another tool to help enforce the noncustodial parent’s child support obligations.\textsuperscript{225} Thus, this supports the current default rule for the dependency exemption — it should be allocated to the custodial parent unless there is an election otherwise.

As to the allocation of power, in order for the default rule for the allocation of the dependency exemption to have the above-intended distributional impact, the custodial parent must have some power over the choice. However, a unilateral choice by the custodial parent would forego the possibility of information-forcing from the custodial parent to the noncustodial parent, which could be valuable if the noncustodial parent was the less-informed party. Thus, given the lack of clarity about which parent is likely to be more informed, both parents should have power over the choice. Currently, the custodial power has unilateral power to release the exemption, but the election actually requires joint action because the noncustodial parent must attach the release form to his tax return. That is, the dependency exemption election requires joint action but not joint decision-making. This could be tweaked slightly to frame the choice more as a cooperative, joint decision by both the custodial and noncustodial parent.

\textbf{B. Largely Indeterminable Individual Preferences — The Employment Example}

In contrast to elections where the taxpayers’ individual preferences are systematically determinable, there may be situations where it is difficult to say much at all about the taxpayers’ individual preferences. Where individual preferences vary based on individual facts and circumstances that are difficult to define ex ante, designing a preference-meeting default rule would be extremely difficult (if even possible). Consider, for example, the

\textsuperscript{223} See generally BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 21.01 (3d ed. 2010).
\textsuperscript{224} Cf. Weitzman, supra note 91, at 395–406 (discussing concerns about “bargaining leverage, economic vulnerability and lack of information” for divorcing women).
\textsuperscript{225} See, e.g., Maples, supra note 103, at 28. Note that this analysis points toward the same result as the penalty default analysis does, at least under the assumption that the noncustodial parent is the primary breadwinner.
employment context and the section 83(b) election. When an employer transfers restricted property in compensation for services, it is not clear whether the employee would rather have current or deferred compensation, whether the employer would rather have a current or deferred compensation deduction, and which choice would minimize the employee's and employer's aggregate tax burden (particularly if their individual preferences are not aligned). Thus, it is difficult to generalize about what default treatment would best meet either or both parties' individual preferences.\textsuperscript{226}

Similarly, without knowing the taxpayers' individual preferences, it would be quite difficult to design a penalty default rule, even if the directionality of the information asymmetry is clear.\textsuperscript{227} And, where the directionality of the information asymmetry is unclear, the penalty default approach is basically futile. For example, with the section 83(b) election, the direction of the desired information flow is not clear because the employer, as a repeat player in issuances of restricted property for services, may have more information about the law, but the employee may have more information about the facts (particularly if the vesting of the property depends on the employee continuing to stay with the employer for a certain period of time). Thus, query which party policymakers would try to "penalize" through a penalty default rule.

Thus, the indeterminacy of the penalty default/preference-meeting default analysis leaves policymakers reliant upon general tax norms and distributional objectives when designing the parameters for these elections. For example, one issue that is common to both the employee and employer in section 83(b) situation is that both face a valuation problem. It is often difficult to value accurately property that is nontransferable and subject to forfeiture. This valuation problem complicates the current inclusion/deduction tax treatment for both parties; in contrast, when the property becomes transferable or nonforfeitable, it can be easier to value.\textsuperscript{228} Thus, a default rule providing that the income and deduction events are to be deferred until that later time (i.e., the current default rule)\textsuperscript{229} can advance

\begin{footnotes}
\item[226] Note that this difficulty is supported by data that suggests that there is a wide divergence in behavior among employers as to whether they want the section 83(b) election to be made, whether they want it not to be made, or whether they do not have a strong preference. See Blouin & Carter, supra note 51.
\item[227] In this case, it is at least possible to conclude that, regardless of the default rule, the less-informed party should have some power over the election.
\item[228] For example, if the property is transferable, it can be sold to a third party, and that arms-length sale provides very good evidence of the property's value.
\end{footnotes}
simplicity. Moreover, under this default rule, if one of the parties believes that it can value the property and believes that it would be valuable to accelerate the tax event, this default rule encourages the informed party (whoever that may be) to communicate that information to the other party, thereby revealing information about its private valuation and financial/tax status.

As to the allocation of the power to make the election, where the taxpayers' individual preferences are largely indeterminable and where the directionality (or even existence) of informational asymmetries are unclear, the analysis of how the election power should be allocated may also be relatively unclear; as a result, distributional concerns may again play a significant role in the analysis. For example, in the context of the section 83(b) election, a joint election would have framing and compliance benefits, but the information forcing and self-protection benefits of a joint choice are minimal. This is because employers usually have ample information, at least about the law, because they are often repeat players, and because employers are generally in a good position to protect themselves through bargaining or otherwise. Moreover, statutorily mandating that employers have some power over the decision-making process could shift some of the benefit of the election to the employer, and that may not be a desirable distributional consequence. As a result, there is a relatively weak argument for revising the unilateral employee election to make it a joint election shared by the employee and the employer, but the allocation of power for section 83(b) elections presents a very close call.

C. Situationally Determinable Individual Preferences — Corporate Acquisition Election Examples

In some contexts, individual taxpayer preferences may vary depending on the facts and circumstances, but unlike the contexts where such preferences are largely indeterminable, the variations in individual taxpayer preferences that occur are relatively predictable, ex ante, at least in certain situations. As a result, the analysis of the parameters for these elections can be divided and evaluated situation-by-situation, based on the foregoing recommendations. That is, where individual taxpayer preferences vary in ways that are relatively predictable, ex ante, the power allocation and/or default rule may be bifurcated in order to get information forcing benefits in

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230 Further, such a rule may be easier for the Service to administer assuming that valuation is easier when the property becomes transferable or nonforfeitable.

231 See supra Part III.B.1.a (discussing informational asymmetry about private valuation as an impediment to bargaining).
the limited situations where the information has high value, while otherwise avoiding the additional transaction costs that the information forcing approaches can create.

For example, consider the corporate acquisition elections. As discussed earlier, there is likely to be asymmetric information in some situations and not others, and the taxpayers' individual preferences will also vary based on the facts and circumstances; in some situations, taxpayers may even be indifferent to how the transaction is treated for tax purposes. Those situations where there is likely to be asymmetric information and where the less-informed party could be adversely affected as a result can be identified and then analyzed separately.

Recall that there is most likely to be asymmetric information in the situations where a single corporate parent either acquires (in the case of a regular section 338 election) or disposes of (in the case of a section 336(e) election) more than 80% of the vote and value of the stock of a corporate subsidiary from/to multiple different individuals in separate transactions over a twelve month period. In those situations, the corporate parent possesses information about the overall acquisition/disposition plan that the sellers/buyers may not have. To the extent that deemed asset-disposition treatment rather than actual stock disposition treatment is likely to adversely affect the less-informed parties, there is likely to be significant value in selecting election parameters that incentivize the more-informed party to disclose information to those less-informed parties. As discussed herein, both default rules and power allocation rules can incentivize the revelation of information. So, the question is how either or both of those parameters can be tailored to apply to the particular situations where information disclosure is likely to be valuable while still minimizing costs.

One alternative is to bifurcate the default rule — consider imposing a penalty default rule tailored to the situations where a less-informed party has a relatively determinable individual preference and could be adversely affected by the tax treatment, and imposing a preference-meeting default rule (if determinable) in the remainder of the situations.232 For the dispositions of corporate subsidiaries to which section 336(e) elections are available, this would mean using the following default rules: the transaction is treated as a stock disposition if deemed asset disposition treatment would cause the target corporation to take a step-down in the basis of its assets (i.e., the tailored penalty default),233 and otherwise, the transaction is

232 See supra Part IV.B.3.
233 This assumes that the target corporation has some power over whether the election is made.
treated as a deemed asset-disposition (i.e., the residual preference-meeting default).  

Another alternative is to limit the scope of the joint election (i.e., bifurcating the power allocation) — require joint decision-making when information disclosure is likely to be valuable, and allow unilateral decision-making in the remainder of the situations. For dispositions of corporate subsidiaries to which section 336(e) elections are available, this would mean allocating power to choose as follows: joint election between the corporation disposing of the subsidiary stock and the post-transaction target corporation, if asset disposition treatment would cause the target corporation to take a step-down in the basis of its assets (i.e., where the acquirers could be harmed if they lack knowledge about the overall transaction); and otherwise, the corporation disposing of the subsidiary stock could make a unilateral election about whether the transaction is treated as a deemed asset disposition or an actual stock disposition. Note that, when requiring joint action, the target corporation itself, as opposed to the possibly numerous individual acquirers of target stock, is the second party whose consent is required to make the election; this significantly reduces the potential transaction costs of a joint election while still preserving the information forcing benefits.

Of course, these alternatives must be harmonized in a way that facilitates information disclosure and bargaining while minimizing the overall transaction costs. In this situation, it is more cost-effective to bifurcate the power allocation rules rather than the default rules. This is because the bifurcated default rule approach requires that the parties undertake the entire asset disposition versus stock disposition analysis merely to determine the transaction’s tax treatment if the parties fail to act. That seems quite complex and potentially costly for both the taxpayers and the Service. In contrast, with a bifurcated power allocation (and uniform default rule), it is perfectly clear what the tax consequences of a transaction are if the parties fail to act; it is only if one or more of the parties thinks that

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234 See supra Part IV.B.3.
235 See supra note 168 and accompanying text.
236 You might wonder, why not use a unilateral election in this context, and merely allocate that unilateral right to the less-informed party. That is certainly a possibility, but that approach forgoes the compliance benefit of joint elections. Further, when bifurcating the power to make the choice, simplicity may be enhanced if the corporation disposing of the subsidiary stock is treated more uniformly (i.e., where that party will always be involved in any election, regardless of whether the target corporation also has some power).
237 See supra Part IV.A.2.a.
238 Harmonization may produce different results in different circumstances.
an alternative treatment might be preferable, that they must undertake the asset disposition versus stock disposition analysis to determine whether the election can be made unilaterally or jointly.

Of course, this bifurcated power allocation approach, which is contrary to the proposed regulations, requires a uniform default rule that is likely to be disadvantageous to the informed party (i.e., the corporate parent disposing of the subsidiary stock) in the situation where the information revelation is likely to be valuable (i.e., where the transaction target corporation could suffer a step down in the basis of its assets without even knowing that there might be an opportunity to negotiate to avoid that result). This suggests that, when bifurcating the allocation of power, the default rule should treat these corporate dispositions as stock dispositions, unless an election is made.

An additional benefit to this default rule is that the default rule follows the form of the transaction. This generally enhances administrability for the Service because this default rule promotes continuity within the tax treatment of stock dispositions.239 Further, this default rule, which is often undesirable for the parties in the aggregate, can incentivize the taxpayers to inform the government about the details of the transaction in order to obtain the more desirable tax treatment, thereby aiding the government's enforcement powers.240

What about the other corporate acquisition elections? Of course, a separate analysis needs to be done for each. Rather than belabor the details of that analysis here, I want to focus on two insights arise from that analysis.

First, joint power to elect is most important where there are significant informational asymmetries and the less-informed party can better protect itself from harm if that information is disclosed. Thus, this suggests that the regular section 338 election, which is currently wholly unilateral, should be joint in very limited circumstances where the less-informed party could be adversely affected.241 This also implies that, in situations where one party is indifferent to the tax treatment of the transaction (e.g., in the remaining transactions where a regular section 338 election is available), that party should not be entitled to participate in the election; rather, in those situations, the party affected by the election should have unilateral power to

239 That is, there is not a huge difference in the tax treatment of the acquisition of 79.9% of the stock of a corporate subsidiary and the tax treatment of the acquisition of 80.1% of the stock of a corporate subsidiary.

240 See supra note 187.

241 A regular section 338 election should be made jointly in the case of a QSP of a foreign target corporation that is a CFC. See supra Part IV.A.2.b.
Further, this also suggests that the section 338(h)(10) election need not remain a joint choice. This is because the impediments to bargaining are quite low for section 338(h)(10) transactions and because there is little valuable information to be gained from information sharing among the taxpayers. Nevertheless, on balance, it is reasonable to leave the section 338(h)(10) election as a joint election because parties on both sides of the transaction are generally affected by the choice, because the joint election frames the decision as cooperative, and because the joint election helps to ensure consistent tax treatment by all parties to the transaction.

Second, the similarities among the three elections suggest that, for simplicity and administrability reasons, there should be some coordination among the elections. This is particularly true with respect to the default rules. “Stock disposition” treatment is likely the better default rule for section 336(e) and regular section 338 contexts. Although there is a reasonably good argument that “asset disposition” treatment is the better (more preference-meeting, and transaction cost-reducing) default rule for the section 338(h)(10) context, administrability and predictability of the law is enhanced if all three elections employ the same default — stock disposition treatment. Since the impediments to bargaining are quite low in the section 338(h)(10) context, it seems relatively unproblematic to use a default rule that the parties are likely to want to contract around.

Ultimately, this analysis suggests that the parameters of the corporate acquisition elections should remain unchanged, with two exceptions: in the limited circumstances described herein, both the section 336(e) election and the regular section 338 election should be made jointly rather than unilaterally.

VI. CONCLUSION

In addition to making a few specific recommendations about how to revise certain tax elections, one goal of this article is to highlight the possibility (and, in the case of explicit elections that affect multiple taxpayers, the probability) that taxpayers will privately negotiate among

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242 Thus, just those shareholders that are currently entitled to notice about the regular section 338 election should be empowered to have a role in the decision about whether to make the election. See supra note 65.

243 This default rule generally meets the likely preferences of the parties, and there is unlikely to be asymmetric information in this context where a penalty default would be valuable.

244 There are profit-maximizing businesspeople, both sides likely have full information, and the parties are already in negotiations.
themselves against the backdrop of the tax law in order to best minimize their aggregate taxes. Whether or not this tax planning is desirable, it is important to appreciate that the design of the tax law can focus taxpayers' attention on specific issues for negotiation and can greatly influence the parameters for this bargaining. Thus, this article makes recommendations about how the tax law can be constructed to emphasize or deemphasize issues for cooperative tax planning and can be designed to impede or facilitate this private negotiation. Hopefully, policymakers will take account of this power when designing explicit tax elections and other tax provisions.